

(ii) Any person who is excluded from participating (other than in the capacity of a director) in major policy-making functions of the company by resolution of the board of directors or by the bylaws of the company and who does not in fact participate in such policymaking functions.

CONDITIONS TO ORDERS

§ 225.200 Conditions to Board's section 20 orders.

(a) *Introduction.* Under section 20 of the Glass-Steagall Act (12 U.S.C. 377) and section 4(c)(8) of the Bank Holding Company Act (12 U.S.C. 1843(c)(8)), a nonbank subsidiary of a bank holding company may to a limited extent underwrite and deal in securities for which underwriting and dealing by a member bank is prohibited. Pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934, these so-called section 20 subsidiaries are required to register with the SEC as broker-dealers and are subject to all the financial reporting, anti-fraud and financial responsibility rules applicable to broker-dealers. In addition, transactions between insured depository institutions and their section 20 affiliates are restricted by sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c and 371c-1). The Board expects a section 20 subsidiary, like any other subsidiary of a bank holding company, to be operated prudently. Doing so would include observing corporate formalities (such as the maintenance of separate accounting and corporate records), and instituting appropriate risk management, including independent trading and exposure limits consistent with parent company guidelines.

(b) *Conditions.* As a condition of each order approving establishment of a section 20 subsidiary, a bank holding company shall comply with the following conditions.

(1) *Capital.* (i) A bank holding company shall maintain adequate capital on a fully consolidated basis. If operating a section 20 authorized to underwrite and deal in all types of debt and equity securities, a bank holding company shall maintain strong capital on a fully consolidated basis.

(ii) In the event that a bank or thrift affiliate of a section 20 subsidiary shall become less than well capitalized (as defined in section 38 of the Federal Deposit Insurance Act, 12 U.S.C. 1831o), and the bank holding company shall fail to restore it promptly to the well capitalized level, the Board may, in its discretion, reimpose the funding, credit extension and credit enhancement firewalls contained in its 1989 order allowing underwriting and dealing in bank-ineligible securities,¹ or order the bank holding company to divest the section 20 subsidiary.

(iii) A foreign bank that operates a branch or agency in the United States shall maintain strong capital on a fully consolidated basis at levels above the minimum levels required by the Basle Capital Accord. In the event that the Board determines that the foreign bank's capital has fallen below these levels and the foreign bank fails to restore its capital position promptly, the Board may, in its discretion, reimpose the funding, credit extension and credit enhancement firewalls contained in its 1990 order allowing foreign banks to underwrite and deal in bank-ineligible securities,² or order the foreign bank to divest the section 20 subsidiary.

(2) *Internal controls.* (i) Each bank holding company or foreign bank shall cause its subsidiary banks, thrifts, branches or agencies³ to adopt policies and procedures, including appropriate limits on exposure, to govern their participation in transactions underwritten or arranged by a section 20 affiliate.

(ii) Each bank holding company or foreign bank shall ensure that an independent and thorough credit evaluation has been undertaken in connection with participation by a bank, thrift, or branch or agency in such transactions, and that adequate documentation of

¹Firewalls 5–8, 19, 21 and 22 of *J.P. Morgan & Co., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, and Security Pacific Corp.*, 75 Federal Reserve Bulletin 192, 214–16 (1989).

²Firewalls 5–8, 19, 21 and 22 of *Canadian Imperial Bank of Commerce, The Royal Bank of Canada, Barclays PLC and Barclays Bank PLC*, 76 Federal Reserve Bulletin 158, (1990).

³The terms “branch” and “agency” refer to a U.S. branch and agency of a foreign bank.

that evaluation is maintained for review by examiners of the appropriate federal banking agency and the Federal Reserve.

(3) *Interlocks restriction.* (i) Directors, officers or employees of a bank or thrift subsidiary of a bank holding company, or a bank or thrift subsidiary or branch or agency of a foreign bank, shall not serve as a majority of the board of directors or the chief executive officer of an affiliated section 20 subsidiary.

(ii) Directors, officers or employees of a section 20 subsidiary shall not serve as a majority of the board of directors or the chief executive officer of an affiliated bank or thrift subsidiary or branch or agency, except that the manager of a branch or agency may act as a director of the underwriting subsidiary.

(iii) For purposes of this standard, the manager of a branch or agency of a foreign bank generally will be considered to be the chief executive officer of the branch or agency.

(4) *Customer disclosure*—(i) *Disclosure to section 20 customers.* A section 20 subsidiary shall provide, in writing, to each of its retail customers,⁴ at the time an investment account is opened, the same minimum disclosures, and obtain the same customer acknowledgment, described in the Interagency Statement on Retail Sales of Non-deposit Investment Products (Statement) as applicable in such situations. These disclosures must be provided regardless of whether the section 20 subsidiary is itself engaged in activities through arrangements with a bank that is covered by the Statement.

(ii) *Disclosures accompanying investment advice.* A director, officer, or employee of a bank, thrift, branch or agency may not express an opinion on the value or the advisability of the purchase or the sale of a bank-ineligible security that he or she knows is being underwritten or dealt in by a section 20 affiliate unless he or she notifies the customer of the affiliate's role.

⁴For purposes of this operating standard, a retail customer is any customer that is not an "accredited investor" as defined in 17 CFR 230.501(a).

(5) *Intra-day credit.* Any intra-day extension of credit to a section 20 subsidiary by an affiliated bank, thrift, branch or agency shall be on market terms consistent with section 23B of the Federal Reserve Act.

(6) *Restriction on funding purchases of securities during underwriting period.* No bank, thrift, branch or agency shall knowingly extend credit to a customer secured by, or for the purpose of purchasing, any bank-ineligible security that a section 20 affiliate is underwriting or has underwritten within the past 30 days, unless:

(i) The extension of credit is made pursuant to, and consistent with any conditions imposed in a preexisting line of credit that was not established in contemplation of the underwriting; or

(ii) The extension of credit is made in connection with clearing transactions for the section 20 affiliate.

(7) *Reporting requirement.* (i) Each bank holding company or foreign bank shall submit quarterly to the appropriate Federal Reserve Bank any FOCUS report filed with the NASD or other self-regulatory organizations, and any information required by the Board to monitor compliance with these operating standards and section 20 of the Glass-Steagall Act, on forms provided by the Board.

(ii) In the event that a section 20 subsidiary is required to furnish notice concerning its capitalization to the Securities and Exchange Commission pursuant to 17 CFR 240.17a-11, a copy of the notice shall be filed concurrently with the appropriate Federal Reserve Bank.

(8) *Foreign banks.* A foreign bank shall ensure that any extension of credit by its branch or agency to a section 20 affiliate, and any purchase by such branch or agency, as principal or fiduciary, of securities for which a section 20 affiliate is a principal underwriter, conforms to sections 23A and 23B of the Federal Reserve Act, and that its branches and agencies not advertise or suggest that they are responsible for the obligations of a section 20 affiliate, consistent with section 23B(c) of the Federal Reserve Act.

[62 FR 45306, Aug. 27, 1997, as amended by Reg. Y, 63 FR 14804, Mar. 27, 1998]

APPENDIX A TO PART 225—CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES: RISK-BASED MEASURE

I. OVERVIEW

The Board of Governors of the Federal Reserve System has adopted a risk-based capital measure to assist in the assessment of the capital adequacy of bank holding companies (*banking organizations*).¹ The principal objectives of this measure are to: (i) Make regulatory capital requirements more sensitive to differences in risk profiles among banking organizations; (ii) factor off-balance sheet exposures into the assessment of capital adequacy; (iii) minimize disincentives to holding liquid, low-risk assets; and (iv) achieve greater consistency in the evaluation of the capital adequacy of major banking organizations throughout the world.²

The risk-based capital guidelines include both a definition of capital and a framework for calculating weighted risk assets by assigning assets and off-balance sheet items to broad risk categories. An institution's risk-based capital ratio is calculated by dividing its qualifying capital (the numerator of the ratio) by its weighted risk assets (the denominator).³ The definition of qualifying capital is outlined below in section II, and the procedures for calculating weighted risk assets are discussed in section III. Attachment I illustrates a sample calculation of weighted risk assets and the risk-based capital ratio.

In addition, when certain organizations that engage in trading activities calculate their risk-based capital ratio under this appendix A, they must also refer to appendix E of this part, which incorporates capital

charges for certain market risks into the risk-based capital ratio. When calculating their risk-based capital ratio under this appendix A, such organizations are required to refer to appendix E of this part for supplemental rules to determine qualifying and excess capital, calculate risk-weighted assets, calculate market risk equivalent assets, and calculate risk-based capital ratios adjusted for market risk.

The risk-based capital guidelines also establish a schedule for achieving a minimum supervisory standard for the ratio of qualifying capital to weighted risk assets and provide for transitional arrangements during a phase-in period to facilitate adoption and implementation of the measure at the end of 1992. These interim standards and transitional arrangements are set forth in section IV.

The risk-based guidelines apply on a consolidated basis to bank holding companies with consolidated assets of \$150 million or more. For bank holding companies with less than \$150 million in consolidated assets, the guidelines will be applied on a bank-only basis unless: (a) The parent bank holding company is engaged in nonbank activity involving significant leverage;⁴ or (b) the parent company has a significant amount of outstanding debt that is held by the general public.

The risk-based guidelines are to be used in the inspection and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. Thus, in considering an application filed by a bank holding company, the Federal Reserve will take into account the organization's risk-based capital ratio, the reasonableness of its capital plans, and the degree of progress it has demonstrated toward meeting the interim and final risk-based capital standards.

The risk-based capital ratio focuses principally on broad categories of credit risk, although the framework for assigning assets and off-balance sheet items to risk categories does incorporate elements of transfer risk, as well as limited instances of interest rate and market risk. The risk-based ratio does not, however, incorporate other factors that can affect an organization's financial condition. These factors include overall interest rate exposure; liquidity, funding and market risks; the quality and level of earnings; investment or loan portfolio concentrations; the quality of loans and investments; the effectiveness of loan and investment policies; and management's ability to monitor and control financial and operating risks.

⁴A parent company that is engaged in significant off-balance sheet activities would generally be deemed to be engaged in activities that involve significant leverage.

¹Supervisory ratios that relate capital to total assets for bank holding companies are outlined in appendices B and D of this part.

²The risk-based capital measure is based upon a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Regulations and Supervisory Practices (Basle Supervisors' Committee) and endorsed by the Group of Ten Central Bank Governors. The framework is described in a paper prepared by the BSC entitled "International Convergence of Capital Measurement," July 1988.

³Banking organizations will initially be expected to utilize period-end amounts in calculating their risk-based capital ratios. When necessary and appropriate, ratios based on average balances may also be calculated on a case-by-case basis. Moreover, to the extent banking organizations have data on average balances that can be used to calculate risk-based ratios, the Federal Reserve will take such data into account.

In addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of these other factors, including, in particular, the level and severity of problem and classified assets. For this reason, the final supervisory judgment on an organization's capital adequacy may differ significantly from conclusions that might be drawn solely from the level of the organization's risk-based capital ratio.

The risk-based capital guidelines establish *minimum* ratios of capital to weighted risk assets. In light of the considerations just discussed, banking organizations generally are expected to operate well above the minimum risk-based ratios. In particular, banking organizations contemplating significant expansion proposals are expected to maintain strong capital levels substantially above the minimum ratios and should not allow significant diminution of financial strength below these strong levels to fund their expansion plans. Institutions with high or inordinate levels of risk are also expected to operate above minimum capital standards. In all cases, institutions should hold capital commensurate with the level and nature of the risks to which they are exposed. Banking organizations that do not meet the minimum risk-based standard, or that are otherwise considered to be inadequately capitalized, are expected to develop and implement plans acceptable to the Federal Reserve for achieving adequate levels of capital within a reasonable period of time.

The Board will monitor the implementation and effect of these guidelines in relation to domestic and international developments in the banking industry. When necessary and appropriate, the Board will consider the need to modify the guidelines in light of any significant changes in the economy, financial markets, banking practices, or other relevant factors.

II. DEFINITION OF QUALIFYING CAPITAL FOR THE RISK BASED CAPITAL RATIO

An institution's qualifying total capital consists of two types of capital components: "core capital elements" (comprising tier 1 capital) and "supplementary capital elements" (comprising tier 2 capital). These capital elements and the various limits, restrictions, and deductions to which they are subject, are discussed below and are set forth in Attachment II.

The Federal Reserve will, on a case-by-case basis, determine whether, and if so how much of, any instrument that does not fit wholly within the terms of one of the capital categories set forth below or that does not have an ability to absorb losses commensurate with the capital treatment otherwise specified below will be counted as an element of tier 1 or tier 2 capital. In making such a determination, the Federal Reserve will consider the similarity of the instrument to in-

struments explicitly treated in the guidelines, the ability of the instrument to absorb losses while the institution operates as a going concern, the maturity and redemption features of the instrument, and other relevant terms and factors. To qualify as an element of tier 1 or tier 2 capital, a capital instrument may not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

Redemptions of permanent equity or other capital instruments before stated maturity could have a significant impact on an organization's overall capital structure. Consequently, an organization considering such a step should consult with the Federal Reserve before redeeming any equity or debt capital instrument (prior to maturity) if such redemption could have a material effect on the level or composition of the organization's capital base.⁵

A. The Components of Qualifying Capital

1. *Core capital elements (tier 1 capital).* The tier 1 component of an institution's qualifying capital must represent at least 50 percent of qualifying total capital and may consist of the following items that are defined as core capital elements:

- (i) Common stockholders' equity;
- (ii) Qualifying noncumulative perpetual preferred stock (including related surplus);
- (iii) Qualifying cumulative perpetual preferred stock (including related surplus), subject to certain limitations described below; and
- (iv) Minority interest in the equity accounts of consolidated subsidiaries.

Tier 1 capital is generally defined as the sum of core capital elements⁶ less any amounts of goodwill, other intangible assets, interest-only strips receivables and non-financial equity investments that are required to be deducted in accordance with section II.B. of this appendix A.

a. *Common stockholders' equity.* For purposes of calculating the risk-based capital ratio, common stockholders' equity is limited to common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign currency translation, net of any

⁵ Consultation would not ordinarily be necessary if an instrument were redeemed with the proceeds of, or replaced by, a like amount of a similar or higher quality capital instrument and the organization's capital position is considered fully adequate by the Federal Reserve. In the case of limited-life tier 2 instruments, consultation would generally be obviated if the new security is of equal or greater maturity than the one it replaces.

⁶ [Reserved]

treasury stock; less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values. For this purpose, net unrealized holding gains on such equity securities and net unrealized holding gains (losses) on available-for-sale debt securities are not included in common stockholders' equity.

b. *Perpetual preferred stock.* Perpetual preferred stock is defined as preferred stock that does not have a maturity date, that cannot be redeemed at the option of the holder of the instrument, and that has no other provisions that will require future redemption of the issue. Consistent with these provisions, any perpetual preferred stock with a feature permitting redemption at the option of the issuer may qualify as capital only if the redemption is subject to prior approval of the Federal Reserve. In general, preferred stock will qualify for inclusion in capital only if it can absorb losses while the issuer operates as a going concern (a fundamental characteristic of equity capital) and only if the issuer has the ability and legal right to defer or eliminate preferred dividends.

Perpetual preferred stock in which the dividend is reset periodically based, in whole or in part, upon the banking organization's current credit standing (that is, auction rate perpetual preferred stock, including so-called Dutch auction money market, and remarketable preferred) will not qualify for inclusion in Tier 1 capital.⁷ Such instruments, however, qualify for inclusion in Tier 2 capital.

For bank holding companies, both cumulative and noncumulative perpetual preferred stock qualify for inclusion in Tier 1. However, the aggregate amount of cumulative perpetual preferred stock that may be included in a holding company's tier 1 is limited to one-third of the sum of core capital elements, excluding the cumulative perpetual preferred stock (that is, items i, ii, and iv above). Stated differently, the aggregate amount may not exceed 25 percent of the sum of all core capital elements, including cumulative perpetual preferred stock (that is, items i, ii, iii, and iv above). Any cumulative perpetual preferred stock outstanding in excess of this limit may be included in tier 2 capital without any sublimits within that tier (see discussion below).

⁷Adjustable rate perpetual preferred stock (that is, perpetual preferred stock in which the dividend rate is not affected by the issuer's credit standing or financial condition but is adjusted periodically according to a formula based solely on general market interest rates) may be included in Tier 1 up to the limits specified for perpetual preferred stock.

While the guidelines allow for the inclusion of noncumulative perpetual preferred stock and limited amounts of cumulative perpetual preferred stock in tier 1, it is desirable from a supervisory standpoint that voting common equity remain the dominant form of tier 1 capital. Thus, bank holding companies should avoid overreliance on preferred stock or nonvoting equity elements within tier 1.

c. *Minority interest in equity accounts of consolidated subsidiaries.* This element is included in Tier 1 because, as a general rule, it represents equity that is freely available to absorb losses in operating subsidiaries. While not subject to an explicit sublimit within Tier 1, banking organizations are expected to avoid using minority interest in the equity accounts of consolidated subsidiaries as an avenue for introducing into their capital structures elements that might not otherwise qualify as Tier 1 capital or that would, in effect, result in an excessive reliance on preferred stock within Tier 1. Minority interests in small business investment companies, investment funds that hold nonfinancial equity investments (as defined in section II.B.5.b. of this appendix A), and subsidiaries engaged in nonfinancial activities are not included in the banking organization's Tier 1 or total capital base if the banking organization's interest in the company or fund is held under one of the legal authorities listed in section II.B.5.b. In addition, minority interests in consolidated asset-backed commercial paper programs (as defined in section III.B.6. of this appendix) that are sponsored by a banking organization are not to be included in the organization's Tier 1 or total capital base if the organization excludes the consolidated assets of such programs from risk-weighted assets pursuant to section III.B.6. of this appendix. This capital treatment for minority interests in consolidated asset-backed commercial paper programs will be effective from July 1, 2003 and will expire on April 1, 2004.

2. *Supplementary capital elements (tier 2 capital).* The tier 2 component of an institution's qualifying capital may consist of the following items that are defined as supplementary capital elements:

- (i) Allowance for loan and lease losses (subject to limitations discussed below);
- (ii) Perpetual preferred stock and related surplus (subject to conditions discussed below);
- (iii) Hybrid capital instruments (as defined below), perpetual debt, and mandatory convertible debt securities;
- (iv) Term subordinated debt and intermediate-term preferred stock, including related surplus (subject to limitations discussed below);
- (v) Unrealized holding gains on equity securities (subject to limitations discussed in section II.A.2.e. of this appendix).

The maximum amount of tier 2 capital that may be included in an institution's qualifying total capital is limited to 100 percent of tier 1 capital (net of goodwill, other intangible assets, interest-only strips receivables and nonfinancial equity investments that are required to be deducted in accordance with section II.B. of this appendix A).

The elements of supplementary capital are discussed in greater detail below.⁸

a. *Allowance for loan and lease losses.* Allowances for loan and lease losses are reserves that have been established through a charge against earnings to absorb future losses on loans or lease financing receivables. Allowances for loan and lease losses exclude "allocated transfer risk reserves,"⁹ and reserves created against identified losses.

During the transition period, the risk-based capital guidelines provide for reducing the amount of this allowance that may be included in an institution's total capital. Initially, it is unlimited. However, by year-end 1990, the amount of the allowance for loan and lease losses that will qualify as capital will be limited to 1.5 percent of an institution's weighted risk assets. By the end of the transition period, the amount of the allowance qualifying for inclusion in Tier 2 capital may not exceed 1.25 percent of weighted risk assets.¹⁰

b. *Perpetual preferred stock.* Perpetual preferred stock, as noted above, is defined as preferred stock that has no maturity date, that cannot be redeemed at the option of the holder, and that has no other provisions that will require future redemption of the issue. Such instruments are eligible for inclusion in Tier 2 capital without limit.¹¹

⁸ [Reserved]

⁹ Allocated transfer risk reserves are reserves that have been established in accordance with Section 905(a) of the International Lending Supervision Act of 1983, 12 U.S.C. 3904(a), against certain assets whose value U.S. supervisory authorities have found to be significantly impaired by protracted transfer risk problems.

¹⁰ The amount of the allowance for loan and lease losses that may be included in Tier 2 capital is based on a percentage of gross weighted risk assets. A banking organization may deduct reserves for loan and lease losses in excess of the amount permitted to be included in Tier 2 capital, as well as allocated transfer risk reserves, from the sum of gross weighted risk assets and use the resulting net sum of weighted risk assets in computing the denominator of the risk-based capital ratio.

¹¹ Long-term preferred stock with an original maturity of 20 years or more (including related surplus) will also qualify in this category as an element of Tier 2. If the holder of such an instrument has a right to require

c. *Hybrid capital instruments, perpetual debt, and mandatory convertible debt securities.* Hybrid capital instruments include instruments that are essentially permanent in nature and that have certain characteristics of both equity and debt. Such instruments may be included in Tier 2 without limit. The general criteria hybrid capital instruments must meet in order to qualify for inclusion in Tier 2 capital are listed below:

(1) The instrument must be unsecured; fully paid-up and subordinated to general creditors. If issued by a bank, it must also be subordinated to claims of depositors.

(2) The instrument must not be redeemable at the option of the holder prior to maturity, except with the prior approval of the Federal Reserve. (Consistent with the Board's criteria for perpetual debt and mandatory convertible securities, this requirement implies that holders of such instruments may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.)

(3) The instrument must be available to participate in losses while the issuer is operating as a going concern. (Term subordinated debt would not meet this requirement.) To satisfy this requirement, the instrument must convert to common or perpetual preferred stock in the event that the accumulated losses exceed the sum of the retained earnings and capital surplus accounts of the issuer.

(4) The instrument must provide the option for the issuer to defer interest payments if: a) the issuer does not report a profit in the preceding annual period (defined as combined profits for the most recent four quarters), and b) the issuer eliminates cash dividends on common and preferred stock.

Perpetual debt and mandatory convertible debt securities that meet the criteria set forth in 12 CFR part 225, appendix B, also qualify as unlimited elements of Tier 2 capital for bank holding companies.

d. *Subordinated debt and intermediate-term preferred stock.* (i) The aggregate amount of term subordinated debt (excluding mandatory convertible debt) and intermediate-term preferred stock that may be treated as supplementary capital is limited to 50 percent of Tier 1 capital (net of goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix). Amounts in excess of these limits may be issued and, while not included in the ratio calculation, will be taken into

the issuer to redeem, repay, or repurchase the instrument prior to the original stated maturity, maturity would be defined, for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing banking organization.

account in the overall assessment of an organization's funding and financial condition.

(ii) Subordinated debt and intermediate-term preferred stock must have an original weighted average maturity of at least five years to qualify as supplementary capital.¹² (If the holder has the option to require the issuer to redeem, repay, or repurchase the instrument prior to the stated maturity, maturity would be defined, for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing banking organization.)¹³ In the case of subordinated debt, the instrument must be unsecured and must clearly state on its face that it is not a deposit and is not insured by a Federal agency. Bank holding company debt must be subordinated in the right of payment to all senior indebtedness of the company.

e. *Unrealized gains on equity securities and unrealized gains (losses) on other assets.* Up to 45 percent of pretax net unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on available-for-sale equity securities with readily determinable fair values may be included in supplementary capital. However, the Federal Reserve may exclude all or a portion of these unrealized gains from Tier 2 capital if the Federal Reserve determines that the equity securities are not prudently valued. Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in supplementary capital, but the Federal Reserve may take these unrealized gains (losses) into account as additional factors when assessing an institution's overall capital adequacy.

f. *Revaluation reserves.* i. Such reserves reflect the formal balance sheet restatement or revaluation for capital purposes of asset

carrying values to reflect current market values. The Federal Reserve generally has not included unrealized asset appreciation in capital ratio calculations, although it has long taken such values into account as a separate factor in assessing the overall financial strength of a banking organization.

ii. Consistent with long-standing supervisory practice, the excess of market values over book values for assets held by bank holding companies will generally not be recognized in supplementary capital or in the calculation of the risk-based capital ratio. However, all bank holding companies are encouraged to disclose their equivalent of premises (building) and security revaluation reserves. The Federal Reserve will consider any appreciation, as well as any depreciation, in specific asset values as additional considerations in assessing overall capital strength and financial condition.

B. Deductions from Capital and Other Adjustments

Certain assets are deducted from an organization's capital for the purpose of calculating the risk-based capital ratio.¹⁴ These assets include:

(i)(a) Goodwill—deducted from the sum of core capital elements.

(b) Certain identifiable intangible assets, that is, intangible assets other than goodwill—deducted from the sum of core capital elements in accordance with section II.B.1.b. of this appendix.

(c) Certain credit-enhancing interest-only strips receivables—deducted from the sum of core capital elements in accordance with sections II.B.1.c. through e. of this appendix.

(ii) Investments in banking and finance subsidiaries that are not consolidated for accounting or supervisory purposes, and investments in other designated subsidiaries or associated companies at the discretion of the Federal Reserve—deducted from total capital components (as described in greater detail below).

(iii) Reciprocal holdings of capital instruments of banking organizations—deducted from total capital components.

(iv) Deferred tax assets—portions are deducted from the sum of core capital elements in accordance with section II.B.4. of this Appendix A.

(v) Nonfinancial equity investments—portions are deducted from the sum of core capital elements in accordance with section II.B.5 of this appendix A.

1. *Goodwill and other intangible assets—*a. *Goodwill.* Goodwill is an intangible asset that represents the excess of the purchase price

¹²Unsecured term debt issued by bank holding companies prior to March 12, 1988, and qualifying as secondary capital at the time of issuance continues to qualify as an element of supplementary capital under the risk-based framework, subject to the 50 percent of Tier 1 capital limitation. Bank holding company term debt issued on or after March 12, 1988, must be subordinated in order to qualify as capital.

¹³As a limited-life capital instrument approaches maturity it begins to take on characteristics of a short-term obligation. For this reason, the outstanding amount of term subordinated debt and limited-life preferred stock eligible for inclusion in Tier 2 is reduced, or discounted, as these instruments approach maturity; one-fifth of the original amount (less redemptions) is excluded each year during the instrument's last five years before maturity. When the remaining maturity is less than one year, the instrument is excluded from Tier 2 capital.

¹⁴Any assets deducted from capital in computing the numerator of the ratio are not included in weighted risk assets in computing the denominator of the ratio.

over the fair market value of identifiable assets acquired less liabilities assumed in acquisitions accounted for under the purchase method of accounting. Any goodwill carried on the balance sheet of a bank holding company after December 31, 1992, will be deducted from the sum of core capital elements in determining Tier 1 capital for ratio calculation purposes. Any goodwill in existence before March 12, 1988, is "grandfathered" during the transition period and is not deducted from core capital elements until after December 31, 1992. However, bank holding company goodwill acquired as a result of a merger or acquisition that was consummated on or after March 12, 1988, is deducted immediately.

b. *Other intangible assets.* i. All servicing assets, including servicing assets on assets other than mortgages (i.e., nonmortgage servicing assets), are included in this appendix as identifiable intangible assets. The only types of identifiable intangible assets that may be included in, that is, not deducted from, an organization's capital are readily marketable mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships. The total amount of these assets that may be included in capital is subject to the limitations described below in sections II.B.1.d. and e. of this appendix.

ii. The treatment of identifiable intangible assets set forth in this section generally will be used in the calculation of a bank holding company's capital ratios for supervisory and applications purposes. However, in making an overall assessment of a bank holding company's capital adequacy for applications purposes, the Board may, if it deems appropriate, take into account the quality and composition of an organization's capital, together with the quality and value of its tangible and intangible assets.

c. *Credit-enhancing interest-only strips receivables (I/Os)* i. Credit-enhancing I/Os are on-balance sheet assets that, in form or in substance, represent a contractual right to receive some or all of the interest due on transferred assets and expose the bank holding company to credit risk directly or indirectly associated with transferred assets that exceeds a *pro rata* share of the bank holding company's claim on the assets, whether through subordination provisions or other credit enhancement techniques. Such I/Os, whether purchased or retained, including other similar "spread" assets, may be included in, that is, not deducted from, a bank holding company's capital subject to the limitations described below in sections II.B.1.d. and e. of this appendix.

ii. Both purchased and retained credit-enhancing I/Os, on a non-tax adjusted basis, are included in the total amount that is used for purposes of determining whether a bank holding company exceeds the tier 1 limita-

tion described below in this section. In determining whether an I/O or other types of spread assets serve as a credit enhancement, the Federal Reserve will look to the economic substance of the transaction.

d. *Fair value limitation.* The amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that a bank holding company may include in capital shall be the lesser of 90 percent of their fair value, as determined in accordance with section II.B.1.f. of this appendix, or 100 percent of their book value, as adjusted for capital purposes in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C Report). The amount of credit-enhancing I/Os that a bank holding company may include in capital shall be its fair value. If both the application of the limits on mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships and the adjustment of the balance sheet amount for these assets would result in an amount being deducted from capital, the bank holding company would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

e. *Tier 1 capital limitation.* i. The total amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that may be included in capital, in the aggregate, cannot exceed 100 percent of tier 1 capital. Nonmortgage servicing assets and purchased credit card relationships are subject, in the aggregate, to a separate sublimit of 25 percent of tier 1 capital. In addition, the total amount of credit-enhancing I/Os (both purchased and retained) that may be included in capital cannot exceed 25 percent of tier 1 capital.¹⁵

ii. For purposes of calculating these limitations on mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and credit-enhancing I/Os, tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all identifiable intangible assets other

¹⁵ Amounts of servicing assets, purchased credit card relationships, and credit-enhancing I/Os (both retained and purchased) in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from a bank holding company's core capital elements in determining tier 1 capital. However, identifiable intangible assets (other than mortgage servicing assets and purchased credit card relationships) acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes, although they will continue to be deducted for applications purposes.

than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, but prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any non-financial equity investments.

iii. Bank holding companies may elect to deduct disallowed mortgage servicing assets, disallowed nonmortgage servicing assets, and disallowed credit-enhancing I/Os (both purchased and retained) on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred-tax assets when determining the amount of deferred-tax assets that are dependent upon future taxable income.

f. *Valuation.* Bank holding companies must review the book value of all intangible assets at least quarterly and make adjustments to these values as necessary. The fair value of mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and credit-enhancing I/Os also must be determined at least quarterly. This determination shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account attrition rates. Examiners will review both the book value and the fair value assigned to these assets, together with supporting documentation, during the inspection process. In addition, the Federal Reserve may require, on a case-by-case basis, an independent valuation of a bank holding company's intangible assets or credit-enhancing I/Os.

g. *Growing organizations.* Consistent with long-standing Board policy, banking organizations experiencing substantial growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets or credit-enhancing I/Os.

2. *Investments in certain subsidiaries— a. Unconsolidated banking or finance subsidiaries.* The aggregate amount of investments in banking or finance subsidiaries¹⁶ whose financial statements are not consolidated for accounting or regulatory reporting purposes, regardless of whether the investment is made by the parent bank holding company

or its direct or indirect subsidiaries, will be deducted from the consolidated parent banking organization's total capital components.¹⁷ Generally, investments for this purpose are defined as equity and debt capital investments and any other instruments that are deemed to be capital in the particular subsidiary.

Advances (that is, loans, extensions of credit, guarantees, commitments, or any other forms of credit exposure) to the subsidiary that are not deemed to be capital will generally not be deducted from an organization's capital. Rather, such advances generally will be included in the parent banking organization's consolidated assets and be assigned to the 100 percent risk category, unless such obligations are backed by recognized collateral or guarantees, in which case they will be assigned to the risk category appropriate to such collateral or guarantees. These advances may, however, also be deducted from the consolidated parent banking organization's capital if, in the judgment of the Federal Reserve, the risks stemming from such advances are comparable to the risks associated with capital investments or if the advances involve other risk factors that warrant such an adjustment to capital for supervisory purposes. These other factors could include, for example, the absence of collateral support.

Inasmuch as the assets of unconsolidated banking and finance subsidiaries are not fully reflected in a banking organization's consolidated total assets, such assets may be viewed as the equivalent of off-balance sheet exposures since the operations of an unconsolidated subsidiary could expose the parent organization and its affiliates to considerable risk. For this reason, it is generally appropriate to view the capital resources invested in these unconsolidated entities as primarily supporting the risks inherent in these off-balance sheet assets, and not generally available to support risks or absorb losses elsewhere in the organization.

b. *Other subsidiaries and investments.* The deduction of investments, regardless of whether they are made by the parent bank holding company or by its direct or indirect subsidiaries, from a consolidated banking organization's capital will also be applied in the case of any subsidiaries, that, while consolidated for accounting purposes, are not

¹⁶For this purpose, a banking and finance subsidiary generally is defined as any company engaged in banking or finance in which the parent institution holds directly or indirectly more than 50 percent of the outstanding voting stock, or which is otherwise controlled or capable of being controlled by the parent institution.

¹⁷An exception to this deduction would be made in the case of shares acquired in the regular course of securing or collecting a debt previously contracted in good faith. The requirements for consolidation are spelled out in the instructions to the FR Y-9C Report.

consolidated for certain specified supervisory or regulatory purposes, such as to facilitate functional regulation. For this purpose, aggregate capital investments (that is, the sum of any equity or debt instruments that are deemed to be capital) in these subsidiaries will be deducted from the consolidated parent banking organization's total capital components.¹⁸

Advances (that is, loans, extensions of credit, guarantees, commitments, or any other forms of credit exposure) to such subsidiaries that are not deemed to be capital will generally not be deducted from capital. Rather, such advances will normally be included in the parent banking organization's consolidated assets and assigned to the 100 percent risk category, unless such obligations are backed by recognized collateral or guarantees, in which case they will be assigned to the risk category appropriate to such collateral or guarantees. These advances may, however, be deducted from the consolidated parent banking organization's capital if, in the judgment of the Federal Reserve, the risks stemming from such advances are comparable to the risks associated with capital investments or if such advances involve other risk factors that warrant such an adjustment to capital for supervisory purposes. These other factors could include, for example, the absence of collateral support.¹⁹

In general, when investments in a consolidated subsidiary are deducted from a consolidated parent banking organization's capital, the subsidiary's assets will also be excluded from the consolidated assets of the parent banking organization in order to assess the latter's capital adequacy.²⁰

¹⁸Investments in unconsolidated subsidiaries will be deducted from both Tier 1 and Tier 2 capital. As a general rule, one-half (50 percent) of the aggregate amount of capital investments will be deducted from the bank holding company's Tier 1 capital and one-half (50 percent) from its Tier 2 capital. However, the Federal Reserve may, on a case-by-case basis, deduct a proportionately greater amount from Tier 1 if the risks associated with the subsidiary so warrant. If the amount deductible from Tier 2 capital exceeds actual Tier 2 capital, the excess would be deducted from Tier 1 capital. Bank holding companies' risk-based capital ratios, net of these deductions, must exceed the minimum standards set forth in section IV.

¹⁹In assessing the overall capital adequacy of a banking organization, the Federal Reserve may also consider the organization's fully consolidated capital position.

²⁰If the subsidiary's assets are consolidated with the parent banking organization for financial reporting purposes, this adjustment will involve excluding the subsidiary's assets

The Federal Reserve may also deduct from a banking organization's capital, on a case-by-case basis, investments in certain other subsidiaries in order to determine if the consolidated banking organization meets minimum supervisory capital requirements without reliance on the resources invested in such subsidiaries.

The Federal Reserve will not automatically deduct investments in other unconsolidated subsidiaries or investments in joint ventures and associated companies.²¹ Nonetheless, the resources invested in these entities, like investments in unconsolidated banking and finance subsidiaries, support assets not consolidated with the rest of the banking organization's activities and, therefore, may not be generally available to support additional leverage or absorb losses elsewhere in the banking organization. Moreover, experience has shown that banking organizations stand behind the losses of affiliated institutions, such as joint ventures and associated companies, in order to protect the reputation of the organization as a whole. In some cases, this has led to losses that have exceeded the investments in such organizations.

For this reason, the Federal Reserve will monitor the level and nature of such investments for individual banking organizations and may, on a case-by-case basis, deduct such investments from total capital components, apply an appropriate risk-weighted capital charge against the organization's proportionate share of the assets of its associated companies, require a line-by-line consolidation of the entity (in the event that the parent's control over the entity makes it the functional equivalent of a subsidiary), or otherwise require the organization to operate with a risk-based capital ratio above the minimum.

In considering the appropriateness of such adjustments or actions, the Federal Reserve will generally take into account whether:

(1) The parent banking organization has significant influence over the financial or

on a line-by-line basis from the consolidated parent organization's assets. The parent banking organization's capital ratio will then be calculated on a consolidated basis with the exception that the assets of the excluded subsidiary will not be consolidated with the remainder of the parent banking organization.

²¹The definition of such entities is contained in the instructions to the Consolidated Financial Statements for Bank Holding Companies. Under regulatory reporting procedures, associated companies and joint ventures generally are defined as companies in which the banking organization owns 20 to 50 percent of the voting stock.

managerial policies or operations of the subsidiary, joint venture, or associated company;

(2) The banking organization is the largest investor in the affiliated company; or

(3) Other circumstances prevail that appear to closely tie the activities of the affiliated company to the parent banking organization.

3. *Reciprocal holdings of banking organizations' capital instruments.* Reciprocal holdings of banking organizations' capital instruments (that is, instruments that qualify as Tier 1 or Tier 2 capital) will be deducted from an organization's total capital components for the purpose of determining the numerator of the risk-based capital ratio.

Reciprocal holdings are cross-holdings resulting from formal or informal arrangements in which two or more banking organizations swap, exchange, or otherwise agree to hold each other's capital instruments. Generally, deductions will be limited to intentional cross-holdings. At present, the Board does not intend to require banking organizations to deduct non-reciprocal holdings of such capital instruments.²²

4. *Deferred-tax assets.* a. The amount of deferred-tax assets that is dependent upon future taxable income, net of the valuation allowance for deferred-tax assets, that may be included in, that is, not deducted from, a bank holding company's capital may not exceed the lesser of:

i. The amount of these deferred-tax assets that the bank holding company is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year,²³ or

ii. 10 percent of tier 1 capital.

b. The reported amount of deferred-tax assets, net of any valuation allowance for deferred-tax assets, in excess of the lesser of these two amounts is to be deducted from a banking organization's core capital elements in determining tier 1 capital. For purposes of calculating the 10 percent limitation, tier 1 capital is defined as the sum of core capital elements, net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, but prior to the deduction of any disallowed mortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os, any disallowed deferred-tax assets, and any nonfinancial equity investments. There generally is no limit in tier 1 capital on the amount of deferred-tax assets that can be realized from taxes paid in prior carry-back years or from future reversals of existing taxable temporary differences.

5. *Nonfinancial equity investments—*a. *General.* A bank holding company must deduct from its core capital elements the sum of the appropriate percentages (as determined below) of the adjusted carrying value of all nonfinancial equity investments held by the parent bank holding company or by its direct or indirect subsidiaries. For purposes of this section II.B.5, investments held by a bank holding company include all investments held directly or indirectly by the bank holding company or any of its subsidiaries.

b. *Scope of nonfinancial equity investments.* A nonfinancial equity investment means any equity investment held by the bank holding company: under the merchant banking authority of section 4(k)(4)(H) of the BHC Act and subpart J of the Board's Regulation Y (12 CFR 225.175 et seq.); under section 4(c)(6) or 4(c)(7) of BHC Act in a nonfinancial company or in a company that makes investments in nonfinancial companies; in a nonfinancial company through a small business investment company (SBIC) under section 302(b) of

²² Deductions of holdings of capital securities also would not be made in the case of interstate "stake out" investments that comply with the Board's Policy Statement on Nonvoting Equity Investments, 12 CFR 225.143 (Federal Reserve Regulatory Service 4-172.1; 68 Federal Reserve Bulletin 413 (1982)). In addition, holdings of capital instruments issued by other banking organizations but taken in satisfaction of debts previously contracted would be exempt from any deduction from capital. The Board intends to monitor nonreciprocal holdings of other banking organizations' capital instruments and to provide information on such holdings to the Basle Supervisors' Committee as called for under the Basle capital framework.

²³ To determine the amount of expected deferred-tax assets realizable in the next 12 months, an institution should assume that all existing temporary differences fully reverse as of the report date. Projected future taxable income should not include net operating loss carry-forwards to be used during that year or the amount of existing tem-

porary differences a bank holding company expects to reverse within the year. Such projections should include the estimated effect of tax-planning strategies that the organization expects to implement to realize net operating losses or tax-credit carry-forwards that would otherwise expire during the year. Institutions do not have to prepare a new 12-month projection each quarter. Rather, on interim report dates, institutions may use the future-taxable income projections for their current fiscal year, adjusted for any significant changes that have occurred or are expected to occur.

the Small Business Investment Act of 1958;²⁴ in a nonfinancial company under the portfolio investment provisions of the Board's Regulation K (12 CFR 211.8(c)(3)); or in a nonfinancial company under section 24 of the Federal Deposit Insurance Act (other than section 24(f)).²⁵ A nonfinancial company is an entity that engages in any activity that has not been determined to be financial in nature or incidental to financial activities under section 4(k) of the Bank Holding Company Act (12 U.S.C. 1843(k)).

c. *Amount of deduction from core capital.* i. The bank holding company must deduct from its core capital elements the sum of the appropriate percentages, as set forth in Table 1, of the adjusted carrying value of all nonfinancial equity investments held by the bank holding company. The amount of the percentage deduction increases as the aggregate amount of nonfinancial equity investments held by the bank holding company increases as a percentage of the bank holding company's Tier 1 capital.

TABLE 1—DEDUCTION FOR NONFINANCIAL EQUITY INVESTMENTS

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the bank holding company (as a percentage of the Tier 1 capital of the parent banking organization) ¹	Deduction from Core Capital Elements (as a percentage of the adjusted carrying value of the investment)
Less than 15 percent	8 percent.
15 percent to 24.99 percent	12 percent.
25 percent and above	25 percent.

¹For purposes of calculating the adjusted carrying value of nonfinancial equity investments as a percentage of Tier 1 capital, Tier 1 capital is defined as the sum of core capital elements net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships, but prior to the deduction for any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

ii. These deductions are applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within the specified ranges of the parent holding company's Tier 1 capital. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank holding company equals 20 percent of the Tier 1 capital of the bank holding company, then the amount of the deduction would be 8 percent of the adjusted carrying value of all investments up to 15 percent of the company's Tier 1 capital, and 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the company's Tier 1 capital.

iii. The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction under this paragraph is excluded from the bank holding company's risk-weighted assets for purposes of com-

puting the denominator of the company's risk-based capital ratio.²⁶

iv. As noted in section I, this appendix establishes *minimum* risk-based capital ratios and banking organizations are at all times expected to maintain capital commensurate with the level and nature of the risks to which they are exposed. The risk to a banking organization from nonfinancial equity investments increases with its concentration in such investments and strong capital levels above the minimum requirements are particularly important when a banking organization has a high degree of concentration in nonfinancial equity investments (e.g., in excess of 50 percent of Tier 1 capital). The Federal Reserve intends to monitor banking organizations and apply heightened supervision to equity investment activities as appropriate, including where the banking organization has a high degree of concentration

²⁴An equity investment made under section 302(b) of the Small Business Investment Act of 1958 in an SBIC that is not consolidated with the parent banking organization is treated as a nonfinancial equity investment.

²⁵See 12 U.S.C. 1843(c)(6), (c)(7) and (k)(4)(H); 15 U.S.C. 682(b); 12 CFR 211.5(b)(1)(iii); and 12 U.S.C. 1831a. In a case in which the Board of Directors of the FDIC, acting directly in exceptional cases and after a review of the proposed activity, has permitted a lesser capital deduction for an investment approved by the Board of Directors

under section 24 of the Federal Deposit Insurance Act, such deduction shall also apply to the consolidated bank holding company capital calculation so long as the bank's investments under section 24 and SBIC investments represent, in the aggregate, less than 15 percent of the Tier 1 capital of the bank.

²⁶For example, if 8 percent of the adjusted carrying value of a nonfinancial equity investment is deducted from Tier 1 capital, the entire adjusted carrying value of the investment will be excluded from risk-weighted assets in calculating the denominator for the risk-based capital ratio.

in nonfinancial equity investments, to ensure that each organization maintains capital levels that are appropriate in light of its equity investment activities. The Federal Reserve also reserves authority to impose a higher capital charge in any case where the circumstances, such as the level of risk of the particular investment or portfolio of investments, the risk management systems of the banking organization, or other information, indicate that a higher minimum capital requirement is appropriate.

d. *SBIC investments.* i. No deduction is required for nonfinancial equity investments that are held by a bank holding company through one or more SBICs that are consolidated with the bank holding company or in one or more SBICs that are not consolidated with the bank holding company to the extent that all such investments, in the aggregate, do not exceed 15 percent of the aggregate of the bank holding company's pro rata interests in the Tier 1 capital of its subsidiary banks. Any nonfinancial equity investment that is held through or in an SBIC and not required to be deducted from Tier 1 capital under this section II.B.5.d. will be assigned a 100 percent risk-weight and included in the parent holding company's consolidated risk-weighted assets.²⁷

ii. To the extent the adjusted carrying value of all nonfinancial equity investments that a bank holding company holds through

one or more SBICs that are consolidated with the bank holding company or in one or more SBICs that are not consolidated with the bank holding company exceeds, in the aggregate, 15 percent of the aggregate Tier 1 capital of the company's subsidiary banks, the appropriate percentage of such amounts (as set forth in Table 1) must be deducted from the bank holding company's core capital elements. In addition, the aggregate adjusted carrying value of *all* nonfinancial equity investments held through a consolidated SBIC and in a non-consolidated SBIC (including any investments for which no deduction is required) must be included in determining, for purposes of Table 1, the total amount of nonfinancial equity investments held by the bank holding company in relation to its Tier 1 capital.

e. *Transition provisions.* No deduction under this section II.B.5 is required to be made with respect to the adjusted carrying value of any nonfinancial equity investment (or portion of such an investment) that was made by the bank holding company prior to March 13, 2000, or that was made after such date pursuant to a binding written commitment²⁸ entered into by the bank holding company prior to March 13, 2000, provided that in either case the bank holding company has continuously held the investment since the relevant investment date.²⁹ For

²⁷ If a bank holding company has an investment in an SBIC that is consolidated for accounting purposes but that is not wholly owned by the bank holding company, the adjusted carrying value of the bank holding company's nonfinancial equity investments through the SBIC is equal to the holding company's proportionate share of the adjusted carrying value of the SBIC's equity investments in nonfinancial companies. The remainder of the SBIC's adjusted carrying value (*i.e.* the minority interest holders' proportionate share) is excluded from the risk-weighted assets of the bank holding company. If a bank holding company has an investment in a SBIC that is not consolidated for accounting purposes and has current information that identifies the percentage of the SBIC's assets that are equity investments in nonfinancial companies, the bank holding company may reduce the adjusted carrying value of its investment in the SBIC proportionately to reflect the percentage of the adjusted carrying value of the SBIC's assets that are not equity investments in nonfinancial companies. If a bank holding company reduces the adjusted carrying value of its investment in a non-consolidated SBIC to reflect financial investments of the SBIC, the amount of the adjustment will be risk weighted at 100 percent and included in the bank's risk-weighted assets.

²⁸ A "binding written commitment" means a legally binding written agreement that requires the banking organization to acquire shares or other equity of the company, or make a capital contribution to the company, under terms and conditions set forth in the agreement. Options, warrants, and other agreements that give a banking organization the right to acquire equity or make an investment, but do not require the banking organization to take such actions, are not considered a binding written commitment for purposes of this section II.B.5.

²⁹ For example, if a bank holding company made an equity investment in 100 shares of a nonfinancial company prior to March 13, 2000, that investment would not be subject to a deduction under this section II.B.5. However, if the bank holding company made any additional equity investment in the company after March 13, 2000, such as by purchasing additional shares of the company (including through the exercise of options or warrants acquired before or after March 13, 2000) or by making a capital contribution to the company, and such investment was not made pursuant to a binding written commitment entered into before March 13, 2000, the adjusted carrying value of the additional investment would be subject to a deduction under this section II.B.5. In addition, if the bank holding company sold and repurchased shares of the company after March 13, 2000,

purposes of this section II.B.5.e., a nonfinancial equity investment made prior to March 13, 2000, includes any shares or other interests received by the bank holding company through a stock split or stock dividend on an investment made prior to March 13, 2000, provided the bank holding company provides no consideration for the shares or interests received and the transaction does not materially increase the bank's holding company's proportional interest in the company. The exercise on or after March 13, 2000, of options or warrants acquired prior to March 13, 2000, is *not* considered to be an investment made prior to March 13, 2000, if the bank holding company provides any consideration for the shares or interests received upon exercise of the options or warrants. Any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section II.B.5.e. must be included in determining the total amount of nonfinancial equity investments held by the bank holding company in relation to its Tier 1 capital for purposes of Table 1. In addition, any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section II.B.5.e. will be assigned a 100-percent risk weight and included in the bank holding company's consolidated risk-weighted assets.

f. *Adjusted carrying value.* i. For purposes of this section II.B.5., the "adjusted carrying value" of investments is the aggregate value at which the investments are carried on the balance sheet of the consolidated bank holding company reduced by any unrealized gains on those investments that are reflected in such carrying value but excluded from the bank holding company's Tier 1 capital and associated deferred tax liabilities. For example, for investments held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of the investments (as reflected on the consolidated balance sheet of the bank holding company) *less* any unrealized

gains on those investments that are included in other comprehensive income and not reflected in Tier 1 capital, and associated deferred tax liabilities.³⁰

ii. As discussed above with respect to consolidated SBICs, some equity investments may be in companies that are consolidated for accounting purposes. For investments in a nonfinancial company that is consolidated for accounting purposes under generally accepted accounting principles, the parent banking organization's adjusted carrying value of the investment is determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the consolidated bank holding company's core capital in accordance with section II.B.1 of this Appendix). Even though the assets of the nonfinancial company are consolidated for accounting purposes, these assets (as well as the credit equivalent amounts of the company's off-balance sheet items) should be excluded from the banking organization's risk-weighted assets for regulatory capital purposes.

g. *Equity investments.* For purposes of this section II.B.5., an equity investment means any equity instrument (including common stock, preferred stock, partnership interests, interests in limited liability companies, trust certificates and warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity where the instrument or feature is held under one of the legal authorities listed in section II.B.5.b. of this appendix. An investment in any other instrument (including subordinated debt) may be treated as an equity investment if, in the judgment of the Federal Reserve, the instrument is the functional equivalent of equity or exposes the state member bank to essentially the same risks as an equity instrument.

ATTACHMENT II—SUMMARY OF DEFINITION OF QUALIFYING CAPITAL FOR BANK HOLDING COMPANIES*

[Using the Year-End 1992 Standard]

Components	Minimum requirements
CORE CAPITAL (Tier 1)	Must equal or exceed 4% of weighted-risk assets.
Common stockholders' equity	No limit.
Qualifying noncumulative perpetual preferred stock	No limit; bank holding companies should avoid undue reliance on preferred stock in tier 1.
Qualifying cumulative perpetual preferred stock	Limited to 25% of the sum of common stock, qualifying perpetual stock, and minority interests.
Minority interest in equity accounts of consolidated subsidiaries.	Organizations should avoid using minority interests to introduce elements not otherwise qualifying for tier 1 capital.

the adjusted carrying value of the re-acquired shares would be subject to a deduction under this section II.B.5.

³⁰Unrealized gains on AFS investments may be included in supplementary capital to

the extent permitted under section II.A.2.e of this appendix A. In addition, the unrealized losses on AFS equity investments are deducted from Tier 1 capital in accordance with section II.A.1.a of this appendix A.

ATTACHMENT II—SUMMARY OF DEFINITION OF QUALIFYING CAPITAL FOR BANK HOLDING COMPANIES*—Continued

[Using the Year-End 1992 Standard]

Components	Minimum requirements
Less: Goodwill, other intangible assets, credit-enhancing interest-only strips and nonfinancial equity investments required to be deducted from capital ¹	
SUPPLEMENTARY CAPITAL (Tier 2)	Total of tier 2 is limited to 100% of tier 1. ²
Allowance for loan and lease losses	Limited to 1.25% of weighted-risk assets. ²
Perpetual preferred stock	No limit within tier 2.
Hybrid capital instruments and equity contract notes	No limit within tier 2.
Subordinated debt and intermediate-term preferred stock (original weighted average maturity of 5 years or more).	Subordinated debt and intermediate-term preferred stock are limited to 50% of tier 1 ² ; amortized for capital purposes as they approach maturity.
Revaluation reserves (equity and building)	Not included; organizations encouraged to disclose; may be evaluated on a case-by-case basis for international comparisons; and taken into account in making an overall assessment of capital.
DEDUCTIONS (from sum of tier 1 and tier 2)	
Investments in unconsolidated subsidiaries	As a general rule, one-half of the aggregate investments will be deducted from tier 1 capital and one-half from tier 2 capital. ³
Reciprocal holdings of banking organizations' capital securities	
Other deductions (such as other subsidiaries or joint ventures) as determined by supervisory authority.	On a case-by-case basis or as a matter of policy after a formal rulemaking.
TOTAL CAPITAL (tier 1 + tier 2 – deductions)	Must equal or exceed 8% of weighted-risk assets.

¹ Requirements for the deduction of other intangible assets and residual interests are set forth in section II.B.1. of this appendix.

² Amounts in excess of limitations are permitted but do not qualify as capital.

³ A proportionately greater amount may be deducted from tier 1 capital, if the risks associated with the subsidiary so warrant.

*See discussion in section II of the guidelines for a complete description of the requirements for, and the limitations on, the components of qualifying capital.

III. PROCEDURES FOR COMPUTING WEIGHTED RISK ASSETS AND OFF-BALANCE SHEET ITEMS

A. Procedures

Assets and credit equivalent amounts of off-balance sheet items of bank holding companies are assigned to one of several broad risk categories, according to the obligor, or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar value of the amount in each category is then multiplied by the risk weight associated with that category. The resulting weighted values from each of the risk categories are added together, and this sum is the banking organization's total weighted risk assets that comprise the denominator of the risk-based capital ratio. Attachment I provides a sample calculation.

Risk weights for all off-balance sheet items are determined by a two-step process. First, the "credit equivalent amount" of off-balance sheet items is determined, in most cases, by multiplying the off-balance sheet item by a credit conversion factor. Second, the credit equivalent amount is treated like any balance sheet asset and generally is assigned to the appropriate risk category according to the obligor, or, if relevant, the guarantor or the nature of the collateral.

In general, if a particular item qualifies for placement in more than one risk category, it is assigned to the category that has the lowest risk weight. A holding of a U.S. municipal revenue bond that is fully guaranteed by

a U.S. bank, for example, would be assigned the 20 percent risk weight appropriate to claims guaranteed by U.S. banks, rather than the 50 percent risk weight appropriate to U.S. municipal revenue bonds.³¹

³¹ An investment in shares of a fund whose portfolio consists primarily of various securities or money market instruments that, if held separately, would be assigned to different risk categories, generally is assigned to the risk category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the stated investment objectives set forth in the prospectus. An organization may, at its option, assign a fund investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus. In no case will an investment in shares in any fund be assigned to a total risk weight of less than 20 percent. If an organization chooses to assign a fund investment on a pro rata basis, and the sum of the investment limits of assets in the fund's prospectus exceeds 100 percent, the organization must assign risk weights in descending order. If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a

The Federal Reserve will, on a case-by-case basis, determine the appropriate risk weight for any asset or credit equivalent amount of an off-balance sheet item that does not fit wholly within the terms of one of the risk weight categories set forth below or that imposes risks on a bank holding company that are incommensurate with the risk weight otherwise specified below for the asset or off-balance sheet item. In addition, the Federal Reserve will, on a case-by-case basis, determine the appropriate credit conversion factor for any off-balance sheet item that does not fit wholly within the terms of one of the credit conversion factors set forth below or that imposes risks on a banking organization that are incommensurate with the credit conversion factors otherwise specified below for the off-balance sheet item. In making such a determination, the Federal Reserve will consider the similarity of the asset or off-balance sheet item to assets or off-balance sheet items explicitly treated in the guidelines, as well as other relevant factors.

B. Collateral, Guarantees, and Other Considerations

1. *Collateral.* The only forms of collateral that are formally recognized by the risk-based capital framework are: Cash on deposit in a subsidiary lending institution; securities issued or guaranteed by the central governments of the OECD-based group of countries;³² U.S. Government agencies, or U.S.

preferential risk weight, such securities generally will be disregarded when determining the risk category into which the organization's holding in the overall fund should be assigned. The prudent use of hedging instruments by a fund to reduce the risk of its assets will not increase the risk weighting of the fund investment. For example, the use of hedging instruments by a fund to reduce the interest rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if a fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk category.

³² The OECD-based group of countries comprises all full members of the Organization for Economic Cooperation and Development (OECD) regardless of entry date, as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements to Borrow, but excludes any country that has rescheduled its external sovereign debt within the previous five years. As of November 1995, the OECD included the following countries: Aus-

tralia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States; and Saudi Arabia had concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow. A rescheduling of external sovereign debt generally would include any renegotiation of terms arising from a country's inability or unwillingness to meet its external debt service obligations, but generally would not include renegotiations of debt in the normal course of business, such as a renegotiation to allow the borrower to take advantage of a decline in interest rates or other change in market conditions.

Government-sponsored agencies; and securities issued by multilateral lending institutions or regional development banks. Claims fully secured by such collateral generally are assigned to the 20 percent risk-weight category. Collateralized transactions meeting all the conditions described in section III.C.1. may be assigned a zero percent risk weight. With regard to collateralized claims that may be assigned to the 20 percent risk-weight category, the extent to which qualifying securities are recognized as collateral is determined by their current market value. If such a claim is only partially secured, that is, the market value of the pledged securities is less than the face amount of a balance-sheet asset or an off-balance-sheet item, the portion that is covered by the market value of the qualifying collateral is assigned to the 20 percent risk category, and the portion of the claim that is not covered by collateral in the form of cash or a qualifying security is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor. For example, to the extent that a claim on a private sector obligor is collateralized by the current market value of U.S. Government securities, it would be placed in the 20 percent risk category and the balance would be assigned to the 100 percent risk category.

2. *Guarantees.* Guarantees of the OECD and non-OECD central governments, U.S. Government agencies, U.S. Government-sponsored agencies, state and local governments of the OECD-based group of countries, multilateral lending institutions and regional development banks, U.S. depository institutions, and foreign banks are also recognized. If a claim is partially guaranteed, that is, coverage of the guarantee is less than the face amount of a balance sheet asset or an off-balance sheet item, the portion that is not fully covered by the guarantee is assigned to the risk category appropriate to the obligor or, if relevant, to any collateral.

tralia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States; and Saudi Arabia had concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow. A rescheduling of external sovereign debt generally would include any renegotiation of terms arising from a country's inability or unwillingness to meet its external debt service obligations, but generally would not include renegotiations of debt in the normal course of business, such as a renegotiation to allow the borrower to take advantage of a decline in interest rates or other change in market conditions.

The face amount of a claim covered by two types of guarantees that have different risk weights, such as a U.S. Government guarantee and a state guarantee, is to be apportioned between the two risk categories appropriate to the guarantors.

The existence of other forms of collateral or guarantees that the risk-based capital framework does not formally recognize may be taken into consideration in evaluating the risks inherent in an organization's loan portfolio—which, in turn, would affect the overall supervisory assessment of the organization's capital adequacy.

3. *Recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities.* Direct credit substitutes, assets transferred with recourse, and securities issued in connection with asset securitizations and structured financings are treated as described below. The term "asset securitizations" or "securitizations" in this rule includes structured financings, as well as asset securitization transactions.

a. *Definitions*—i. *Credit derivative* means a contract that allows one party (the "protection purchaser") to transfer the credit risk of an asset or off-balance sheet credit exposure to another party (the "protection provider"). The value of a credit derivative is dependent, at least in part, on the credit performance of the "reference asset."

ii. *Credit-enhancing representations and warranties* means representations and warranties that are made or assumed in connection with a transfer of assets (including loan servicing assets) and that obligate the bank holding company to protect investors from losses arising from credit risk in the assets transferred or the loans serviced. Credit-enhancing representations and warranties include promises to protect a party from losses resulting from the default or nonperformance of another party or from an insufficiency in the value of the collateral. Credit-enhancing representations and warranties do not include:

1. Early default clauses and similar warranties that permit the return of, or premium refund clauses covering, 1-4 family residential first mortgage loans that qualify for a 50 percent risk weight for a period not to exceed 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of transfer;

2. Premium refund clauses that cover assets guaranteed, in whole or in part, by the U.S. Government, a U.S. Government agency or a government-sponsored enterprise, provided the premium refund clauses are for a period not to exceed 120 days from the date of transfer; or

3. Warranties that permit the return of assets in instances of misrepresentation, fraud or incomplete documentation.

iii. *Direct credit substitute* means an arrangement in which a bank holding company *assumes*, in form or in substance, credit risk associated with an on- or off-balance sheet credit exposure that was not previously owned by the bank holding company (third-party asset) and the risk assumed by the bank holding company exceeds the *pro rata* share of the bank holding company's interest in the third-party asset. If the bank holding company has no claim on the third-party asset, then the bank holding company's assumption of *any* credit risk with respect to the third-party asset is a direct credit substitute. Direct credit substitutes include, but are not limited to:

1. Financial standby letters of credit that support financial claims on a third party that exceed a bank holding company's *pro rata* share of losses in the financial claim;

2. Guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims that exceed a bank holding company's *pro rata* share in the financial claim;

3. Purchased subordinated interests or securities that absorb more than their *pro rata* share of losses from the underlying assets;

4. Credit derivative contracts under which the bank holding company assumes more than its *pro rata* share of credit risk on a third party exposure;

5. Loans or lines of credit that provide credit enhancement for the financial obligations of an account party;

6. Purchased loan servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced. Mortgage servicer cash advances that meet the conditions of section III.B.3.a.viii. of this appendix are not direct credit substitutes; and

7. Clean-up calls on third party assets are direct credit substitutes. Clean-up calls that are 10 percent or less of the original pool balance that are exercisable at the option of the bank holding company are not direct credit substitutes.

iv. *Externally rated* means that an instrument or obligation has received a credit rating from a nationally-recognized statistical rating organization.

v. *Face amount* means the notional principal, or face value, amount of an off-balance sheet item; the amortized cost of an asset not held for trading purposes; and the fair value of a trading asset.

vi. *Financial asset* means cash or other monetary instrument, evidence of debt, evidence of an ownership interest in an entity, or a contract that conveys a right to receive or exchange cash or another financial instrument from another party.

vii. *Financial standby letter of credit* means a letter of credit or similar arrangement

that represents an irrevocable obligation to a third-party beneficiary:

1. To repay money borrowed by, or advanced to, or for the account of, a second party (the account party), or

2. To make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

viii. *Mortgage servicer cash advance* means funds that a residential mortgage loan servicer advances to ensure an uninterrupted flow of payments, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the loan. A mortgage servicer cash advance is not a recourse obligation or a direct credit substitute if:

1. The servicer is entitled to full reimbursement and this right is not subordinated to other claims on the cash flows from the underlying asset pool; or

2. For any one loan, the servicer's obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal balance of that loan.

ix. *Nationally recognized statistical rating organization (NRSRO)* means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission (or any successor Division) (Commission) as a nationally recognized statistical rating organization for various purposes, including the Commission's uniform net capital requirements for brokers and dealers.

x. *Recourse* means the retention, by a bank holding company, in form or in substance, of any credit risk directly or indirectly associated with an asset it has transferred and sold that exceeds a *pro rata* share of the banking organization's claim on the asset. If a banking organization has no claim on a transferred asset, then the retention of any risk of credit loss is recourse. A recourse obligation typically arises when a bank holding company transfers assets and retains an explicit obligation to repurchase the assets or absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if a bank holding company provides credit enhancement beyond any contractual obligation to support assets it has sold. The following are examples of recourse arrangements:

1. Credit-enhancing representations and warranties made on the transferred assets;

2. Loan servicing assets retained pursuant to an agreement under which the bank holding company will be responsible for credit losses associated with the loans being serviced. Mortgage servicer cash advances that meet the conditions of section III.B.3.a.viii. of this appendix are not recourse arrangements;

3. Retained subordinated interests that absorb more than their *pro rata* share of losses from the underlying assets;

4. Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet;

5. Loan strips sold without contractual recourse where the maturity of the transferred loan is shorter than the maturity of the commitment under which the loan is drawn;

6. Credit derivatives issued that absorb more than the bank holding company's *pro rata* share of losses from the transferred assets; and

7. Clean-up calls at inception that are greater than 10 percent of the balance of the original pool of transferred loans. Clean-up calls that are 10 percent or less of the original pool balance that are exercisable at the option of the bank holding company are not recourse arrangements.

xi. *Residual interest* means any on-balance sheet asset that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with generally accepted accounting principles) of financial assets, whether through a securitization or otherwise, and that exposes the bank holding company to credit risk directly or indirectly associated with the transferred assets that exceeds a *pro rata* share of the bank holding company's claim on the assets, whether through subordination provisions or other credit enhancement techniques. Residual interests generally include credit-enhancing I/Os, spread accounts, cash collateral accounts, retained subordinated interests, other forms of over-collateralization, and similar assets that function as a credit enhancement. Residual interests further include those exposures that, in substance, cause the bank holding company to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold. Residual interests generally do not include interests purchased from a third party, except that purchased credit-enhancing I/Os are residual interests for purposes of this appendix.

xii. *Risk participation* means a participation in which the originating party remains liable to the beneficiary for the full amount of an obligation (e.g., a direct credit substitute) notwithstanding that another party has acquired a participation in that obligation.

xiii. *Securitization* means the pooling and repackaging by a special purpose entity of assets or other credit exposures into securities that can be sold to investors. Securitization includes transactions that create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

xiv. *Sponsor* means a bank holding company that establishes an asset-backed commercial paper program; approves the sellers

permitted to participate in the program; approves the asset pools to be purchased by the program; or administers the asset-backed commercial paper program by monitoring the assets, arranging for debt placement, compiling monthly reports, or ensuring compliance with the program documents and with the program's credit and investment policy.

xv. *Structured finance program* means a program where receivable interests and asset-backed securities issued by multiple participants are purchased by a special purpose entity that repackages those exposures into securities that can be sold to investors. Structured finance programs allocate credit risks, generally, between the participants and credit enhancement provided to the program.

xvi. *Traded position* means a position that is externally rated, and is retained, assumed, or issued in connection with an asset securitization, where there is a reasonable expectation that, in the near future, the rating will be relied upon by unaffiliated investors to purchase the position; or an unaffiliated third party to enter into a transaction involving the position, such as a purchase, loan, or repurchase agreement.

b. *Credit equivalent amounts and risk weight of recourse obligations and direct credit substitutes.* i. *Credit equivalent amount.* Except as otherwise provided in sections III.B.3.c. through f. and III.B.5. of this appendix, the credit-equivalent amount for a recourse obligation or direct credit substitute is the full amount of the credit-enhanced assets for which the bank holding company directly or indirectly retains or assumes credit risk multiplied by a 100 percent conversion factor.

ii. *Risk-weight factor.* To determine the bank holding company's risk-weight factor for off-balance sheet recourse obligations

and direct credit substitutes, the credit equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. For a direct credit substitute that is an on-balance sheet asset (e.g., a purchased subordinated security), a bank holding company must calculate risk-weighted assets using the amount of the direct credit substitute and the full amount of the assets it supports, i.e., all the more senior positions in the structure. The treatment of direct credit substitutes that have been syndicated or in which risk participations have been conveyed or acquired is set forth in section III.D.1 of this appendix.

c. *Externally-rated positions: credit-equivalent amounts and risk weights of recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities (including asset-backed commercial paper)—i. Traded positions.* With respect to a recourse obligation, direct credit substitute, residual interest (other than a credit-enhancing I/O strip) or asset- and mortgage-backed security (including asset-backed commercial paper) that is a traded position and that has received an external rating on a long-term position that is one grade below investment grade or better or a short-term rating that is investment grade, the bank holding company may multiply the face amount of the position by the appropriate risk weight, determined in accordance with the tables below. Stripped mortgage-backed securities and other similar instruments, such as interest-only or principal-only strips that are not credit enhancements, must be assigned to the 100 percent risk category. If a traded position has received more than one external rating, the lowest single rating will apply.

Long-term rating category	Examples	Risk weight (In percent)
Highest or second highest investment grade	AAA, AA	20
Third highest investment grade	A	50
Lowest investment grade	BBB	100
One category below investment grade	BB	200
Short-term rating	Examples	Risk weight (In percent)
Highest investment grade	A-1, P-1	20
Second highest investment grade	A-2, P-2	50
Lowest investment grade	A-3, P-3	100

ii. *Non-traded positions.* A recourse obligation, direct credit substitute, or residual interest (but not a credit-enhancing I/O strip) extended in connection with a securitization that is not a traded position may be assigned a risk weight in accordance with section III.B.3.c.i. of this appendix if:

1. It has been externally rated by more than one NRSRO;
2. It has received an external rating on a long-term position that is one grade below investment grade or better or on a short-term position that is investment grade by all NRSROs providing a rating;
3. The ratings are publicly available; and

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4. The ratings are based on the same criteria used to rate traded positions.

If the ratings are different, the lowest rating will determine the risk category to which the recourse obligation, direct credit substitute, or residual interest will be assigned.

d. *Senior positions not externally rated.* For a recourse obligation, direct credit substitute, residual interest, or asset-or mortgage-backed security that is not externally rated but is senior or preferred in all features to a traded position (including collateralization and maturity), a bank holding company may apply a risk weight to the face amount of the senior position in accordance with section III.B.3.c.i. of this appendix, based on the traded position, subject to any current or prospective supervisory guidance and the bank holding company satisfying the Federal Reserve that this treatment is appropriate. This section will apply only if the traded subordinated position provides substantive credit support to the unrated position until the unrated position matures.

e. *Capital requirement for residual interests—*
i. *Capital requirement for credit-enhancing I/O strips.* After applying the concentration limit to credit-enhancing I/O strips (both purchased and retained) in accordance with sections II.B.2.c. through e. of this appendix, a bank holding company must maintain risk-based capital for a credit-enhancing I/O strip (both purchased and retained), regardless of the external rating on that position, equal to the remaining amount of the credit-enhancing I/O (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred credit-enhancing I/O strip will be treated as if the credit-enhancing I/O strip was retained

by the bank holding company and not transferred.

ii. *Capital requirement for other residual interests.* 1. If a residual interest does not meet the requirements of sections III.B.3.c. or d. of this appendix, a bank holding must maintain risk-based capital equal to the remaining amount of the residual interest that is retained on the balance sheet (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred residual interest will be treated as if the residual interest was retained by the bank holding company and not transferred.

2. Where the aggregate capital requirement for residual interests and other recourse obligations in connection with the same transfer of assets exceed the full risk-based capital requirement for those assets, a bank holding company must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest as calculated under section III.B.3.e.ii.1. of this appendix or the full risk-based capital requirement for the assets transferred.

f. *Positions that are not rated by an NRSRO.* A position (but not a residual interest) maintained in connection with a securitization and that is not rated by a NRSRO may be risk-weighted based on the bank holding company's determination of the credit rating of the position, as specified in the table below, multiplied by the face amount of the position. In order to obtain this treatment, the bank holding company's system for determining the credit rating of the position must meet one of the three alternative standards set out in sections III.B.3.f.i. through III.B.3.f.iii. of this appendix.

Rating category	Examples	Risk weight (In percent)
Highest or second highest investment grade	AAA, AA	100
Third highest investment grade	A	100
Lowest investment grade	BBB	100
One category below investment grade	BB	200

i. *Internal risk rating used for asset-backed programs.* A direct credit substitute (other than a purchased credit-enhancing I/O) is assumed in connection with an asset-backed commercial paper program sponsored by the bank holding company and the bank holding company is able to demonstrate to the satisfaction of the Federal Reserve, prior to relying upon its use, that the bank holding company's internal credit risk rating system is adequate. Adequate internal credit risk rat-

ing systems usually contain the following criteria:

1. The internal credit risk system is an integral part of the bank holding company's risk management system, which explicitly incorporates the full range of risks arising from a bank holding company's participation in securitization activities;

2. Internal credit ratings are linked to measurable outcomes, such as the probability that the position will experience any

loss, the position's expected loss given default, and the degree of variance in losses given default on that position;

3. The bank holding company's internal credit risk system must separately consider the risk associated with the underlying loans or borrowers, and the risk associated with the structure of a particular securitization transaction;

4. The bank holding company's internal credit risk system must identify gradations of risk among "pass" assets and other risk positions;

5. The bank holding company must have clear, explicit criteria that are used to classify assets into each internal risk grade, including subjective factors;

6. The bank holding company must have independent credit risk management or loan review personnel assigning or reviewing the credit risk ratings;

7. The bank holding company must have an internal audit procedure that periodically verifies that the internal credit risk ratings are assigned in accordance with the established criteria;

8. The bank holding company must monitor the performance of the internal credit risk ratings assigned to nonrated, nontraded direct credit substitutes over time to determine the appropriateness of the initial credit risk rating assignment and adjust individual credit risk ratings, or the overall internal credit risk ratings system, as needed; and

9. The internal credit risk system must make credit risk rating assumptions that are consistent with, or more conservative than, the credit risk rating assumptions and methodologies of NRSROs.

ii. *Program Ratings.* A direct credit substitute or recourse obligation (other than a residual interest) is assumed or retained in connection with a structured finance program and a NRSRO has reviewed the terms of the program and stated a rating for positions associated with the program. If the program has options for different combinations of assets, standards, internal credit enhancements and other relevant factors, and the NRSRO specifies ranges of rating categories to them, the bank holding company may apply the rating category that corresponds to the bank holding company's position. In order to rely on a program rating, the bank holding company must demonstrate to the Federal Reserve's satisfaction that the credit risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. The bank holding company must also demonstrate to the Federal Reserve's satisfaction that the criteria underlying the NRSRO's assignment of ratings for the program are satisfied for the particular position. If a bank holding company participates in a securitization sponsored by another party, the Federal Reserve may authorize

the bank holding company to use this approach based on a programmatic rating obtained by the sponsor of the program.

iii. *Computer Program.* The bank holding company is using an acceptable credit assessment computer program to determine the rating of a direct credit substitute or recourse obligation (but not residual interest) issued in connection with a structured finance program. A NRSRO must have developed the computer program, and the bank holding company must demonstrate to the Federal Reserve's satisfaction that ratings under the program correspond credibly and reliably with the rating of traded positions.

g. *Limitations on risk-based capital requirements—i. Low-level exposure.* If the maximum contractual exposure to loss retained or assumed by a bank holding company in connection with a recourse obligation or a direct credit substitute is less than the effective risk-based capital requirement for the enhanced assets, the risk-based capital requirement is limited to the maximum contractual exposure, less any liability account established in accordance with generally accepted accounting principles. This limitation does not apply when a bank holding company provides credit enhancement beyond any contractual obligation to support assets it has sold.

ii. *Mortgage-related securities or participation certificates retained in a mortgage loan swap.* If a bank holding company holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support the recourse obligation plus the percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of capital required for the on-balance sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the organization continued to hold these loans as on-balance sheet assets.

iii. *Related on-balance sheet assets.* If a recourse obligation or direct credit substitute subject to section III.B.3. of this appendix also appears as a balance sheet asset, the balance sheet asset is not included in an organization's risk-weighted assets to the extent the value of the balance sheet asset is already included in the off-balance sheet credit equivalent amount for the recourse obligation or direct credit substitute, except in the case of loan servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In that case, both the on-balance sheet assets and the related recourse obligations and direct credit substitutes are incorporated into the risk-based capital calculation.

4. *Maturity.* Maturity is generally not a factor in assigning items to risk categories with the exception of claims on non-OECD

banks, commitments, and interest rate and foreign exchange rate contracts. Except for commitments, short-term is defined as one year or less *remaining* maturity and long-term is defined as over one year *remaining* maturity. In the case of commitments, short-term is defined as one year or less *original* maturity and long-term is defined as over one year *original* maturity.

5. *Small Business Loans and Leases on Personal Property Transferred with Recourse.* a. Notwithstanding other provisions of this appendix A, a qualifying banking organization that has transferred small business loans and leases on personal property (small business obligations) with recourse shall include in weighted-risk assets only the amount of retained recourse, provided two conditions are met. First, the transaction must be treated as a sale under GAAP and, second, the banking organization must establish pursuant to GAAP a non-capital reserve sufficient to meet the organization's reasonably estimated liability under the recourse arrangement. Only loans and leases to businesses that meet the criteria for a small business concern established by the Small Business Administration under section 3(a) of the Small Business Act are eligible for this capital treatment.

b. For purposes of this appendix A, a banking organization is qualifying if it meets the criteria for well capitalized or, by order of the Board, adequately capitalized, as those criteria are set forth in the Board's prompt corrective action regulation for state member banks (12 CFR 208.40). For purposes of determining whether an organization meets these criteria, its capital ratios must be calculated without regard to the capital treatment for transfers of small business obligations with recourse specified in section III.B.5.a. of this appendix A. The total outstanding amount of recourse retained by a qualifying banking organization on transfers of small business obligations receiving the preferential capital treatment cannot exceed 15 percent of the organization's total risk-based capital. By order, the Board may approve a higher limit.

c. If a bank holding company ceases to be qualifying or exceeds the 15 percent capital limitation, the preferential capital treatment will continue to apply to any transfers of small business obligations with recourse that were consummated during the time that the organization was qualifying and did not exceed the capital limit.

6. *Asset-backed commercial paper programs.* a. An asset-backed commercial paper (ABCP) program typically is a program through which a banking organization provides funding to its corporate customers by sponsoring and administering a bankruptcy-remote special purpose entity that purchases asset pools from, or extends loans to, the organization's customers. The ABCP program raises the cash to provide the funding through the issuance of commercial paper in the market.

b. A banking organization that qualifies as a primary beneficiary and must consolidate an ABCP program that is defined as a variable interest entity under GAAP may exclude the consolidated ABCP program assets from its risk-weighted assets provided that the bank holding company is the sponsor of the consolidated ABCP program. If a banking organization excludes such ABCP program assets, the banking organization must apply the appropriate risk-based capital charge against any risk exposures of the organization arising in connection with such ABCP programs, including direct credit substitutes, recourse obligations, residual interests, liquidity facilities, and loans, in accordance with sections III.B.3., III.C. and III.D. of this appendix.

c. This capital treatment for consolidated assets of certain ABCP programs will be effective from July 1, 2003 and will expire on April 1, 2004.

C. Risk Weights

Attachment III contains a listing of the risk categories, a summary of the types of assets assigned to each category and the risk weight associated with each category, that is, 0 percent, 20 percent, 50 percent, and 100 percent. A brief explanation of the components of each category follows.

1. *Category 1: zero percent.* This category includes cash (domestic and foreign) owned and held in all offices of subsidiary depository institutions or in transit and gold bullion held in either a subsidiary depository institution's own vaults or in another's vaults on an allocated basis, to the extent it is offset by gold bullion liabilities.³³ The category

³³ All other holdings of bullion are assigned to the 100 percent risk category.

also includes all direct claims (including securities, loans, and leases) on, and the portions of claims that are directly and unconditionally guaranteed by, the central governments³⁴ of the OECD countries and U.S. Government agencies,³⁵ as well as all direct local currency claims on, and the portions of local currency claims that are directly and unconditionally guaranteed by, the central governments of non-OECD countries, to the extent that subsidiary depository institutions have liabilities booked in that currency. A claim is not considered to be unconditionally guaranteed by a central government if the validity of the guarantee is dependent upon some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. Government or its agencies that are actively traded in financial markets, such as GNMA securities, are considered to be unconditionally guaranteed.

This category also includes claims collateralized by cash on deposit in the subsidiary lending institution or by securities issued or guaranteed by OECD central governments or U.S. government agencies for which a positive margin of collateral is

maintained on a daily basis, fully taking into account any change in the banking organization's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim.

2. *Category 2: 20 percent.* a. This category includes cash items in the process of collection, both foreign and domestic; short-term claims (including demand deposits) on, and the portions of short-term claims that are guaranteed by,³⁶ U.S. depository institutions³⁷ and foreign banks³⁸; and long-term claims on, and the portions of long-term claims that are guaranteed by, U.S. depository institutions and OECD banks.³⁹

³⁶ Claims guaranteed by U.S. depository institutions and foreign banks include risk participations in both bankers acceptances and standby letters of credit, as well as participations in commitments, that are conveyed to U.S. depository institutions or foreign banks.

³⁷ U.S. depository institutions are defined to include branches (foreign and domestic) of federally-insured banks and depository institutions chartered and headquartered in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. The definition encompasses banks, mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, and international banking facilities or domestic banks. U.S.-chartered depository institutions owned by foreigners are also included in the definition. However, branches and agencies of foreign banks located in the U.S., as well as all bank holding companies, are excluded.

³⁸ Foreign banks are distinguished as either OECD banks or non-OECD banks. OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries (other than the U.S.) that belong to the OECD-based group of countries. Non-OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries that do not belong to the OECD-based group of countries. For this purpose, a bank is defined as an institution that engages in the business of banking; is recognized as a bank by the bank supervisory or monetary authorities of the country of its organization or principal banking operations; receives deposits to a substantial extent in the regular course of business; and has the power to accept demand deposits.

³⁹ Long-term claims on, or guaranteed by, non-OECD banks and all claims on bank holding companies are assigned to the 100 percent risk category, as are holdings of bank-issued securities that qualify as capital of the issuing banks.

³⁴ A central government is defined to include departments and ministries, including the central bank, of the central government. The U.S. central bank includes the 12 Federal Reserve Banks, and stock held in these banks as a condition of membership is assigned to the zero percent risk category. The definition of central government does not include state, provincial, or local governments; or commercial enterprises owned by the central government. In addition, it does not include local government entities or commercial enterprises whose obligations are guaranteed by the central government, although any claims on such entities guaranteed by central governments are placed in the same general risk category as other claims guaranteed by central governments. OECD central governments are defined as central governments of the OECD-based group of countries; non-OECD central governments are defined as central governments of countries that do not belong to the OECD-based group of countries.

³⁵ A U.S. Government agency is defined as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government. Such agencies include the Government National Mortgage Association (GNMA), the Veterans Administration (VA), the Federal Housing Administration (FHA), the Export-Import Bank (Exim Bank), the Overseas Private Investment Corporation (OPIC), the Commodity Credit Corporation (CCC), and the Small Business Administration (SBA).

b. This category also includes the portions of claims that are conditionally guaranteed by OECD central governments and U.S. Government agencies, as well as the portions of local currency claims that are conditionally guaranteed by non-OECD central governments, to the extent that subsidiary depository institutions have liabilities booked in that currency. In addition, this category also includes claims on, and the portions of claims that are guaranteed by, U.S. government-sponsored⁴⁰ agencies and claims on, and the portions of claims guaranteed by, the International Bank for Reconstruction and Development (World Bank), the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the Nordic Investment Bank, and other multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member. General obligation claims on, or portions of claims guaranteed by the full faith and credit of, states or other political subdivisions of the U.S. or other countries of the OECD-based group are also assigned to this category.⁴¹

c. This category also includes the portions of claims (including repurchase transactions) collateralized by cash on deposit in the subsidiary lending institution or by securities issued or guaranteed by OECD central governments or U.S. government agencies that do not qualify for the zero percent risk-weight category; collateralized by securities issued or guaranteed by U.S. government-sponsored agencies; or collateralized by securities issued by multilateral lending institutions or regional development banks in

which the U.S. government is a shareholder or contributing member.

d. This category also includes claims⁴² on, or guaranteed by, a qualifying securities firm⁴³ incorporated in the United States or other member of the OECD-based group of countries provided that: the qualifying securities firm has a long-term issuer credit rating, or a rating on at least one issue of long-term debt, in one of the three highest investment grade rating categories from a nationally recognized statistical rating organization; or the claim is guaranteed by the firm's parent company and the parent company has such a rating. If ratings are available from more than one rating agency, the lowest rating will be used to determine whether the rating requirement has been met. This category also includes a collateralized claim on a qualifying securities firm in such a country, without regard to satisfaction of the rating standard, provided the claim arises under a contract that:

- (1) Is a reverse repurchase/repurchase agreement or securities lending/borrowing transaction executed under standard industry documentation;
- (2) Is collateralized by debt or equity securities that are liquid and readily marketable;
- (3) Is marked-to-market daily;
- (4) Is subject to a daily margin maintenance requirement under the standard industry documentation; and
- (5) Can be liquidated, terminated, or accelerated immediately in bankruptcy or similar proceeding, and the security or collateral agreement will not be stayed or avoided,

⁴² Claims on a qualifying securities firm that are instruments the firm, or its parent company, uses to satisfy its applicable capital requirement are not eligible for this risk weight.

⁴³ With regard to securities firms incorporated in the United States, qualifying securities firms are those securities firms that are broker-dealers registered with the Securities and Exchange Commission and are in compliance with the SEC's net capital rule, 17 CFR 240.15c3-1. With regard to securities firms incorporated in other countries in the OECD-based group of countries, qualifying securities firms are those securities firms that a banking organization is able to demonstrate are subject to consolidated supervision and regulation (covering their direct and indirect subsidiaries, but not necessarily their parent organizations) comparable to that imposed on banks in OECD countries. Such regulation must include risk-based capital requirements comparable to those applied to banks under the Accord on International Convergence of Capital Measurement and Capital Standards (1988, as amended in 1998) (Basel Accord).

⁴⁰ For this purpose, U.S. government-sponsored agencies are defined as agencies originally established or chartered by the Federal government to serve public purposes specified by the U.S. Congress but whose obligations are *not explicitly* guaranteed by the full faith and credit of the U.S. government. These agencies include the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), the Farm Credit System, the Federal Home Loan Bank System, and the Student Loan Marketing Association (SLMA). Claims on U.S. government-sponsored agencies include capital stock in a Federal Home Loan Bank that is held as a condition of membership in that Bank.

⁴¹ Claims on, or guaranteed by, states or other political subdivisions of countries that do not belong to the OECD-based group of countries are placed in the 100 percent risk category.

under applicable law of the relevant jurisdiction.⁴⁴

3. *Category 3: 50 percent.* This category includes loans fully secured by first liens⁴⁵ on 1- to 4-family residential properties, either owner-occupied or rented, or on multifamily residential properties,⁴⁶ that meet certain criteria.⁴⁷ Loans included in this category must have been made in accordance with prudent underwriting standards;⁴⁸ be per-

⁴⁴For example, a claim is exempt from the automatic stay in bankruptcy in the United States if it arises under a securities contract or repurchase agreement subject to section 555 or 559 of the Bankruptcy Code, respectively (11 U.S.C. 555 or 559), a qualified financial contract under section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401–4407), or the Board's Regulation EE (12 CFR Part 231).

⁴⁵If a banking organization holds the first and junior lien(s) on a residential property and no other party holds an intervening lien, the transaction is treated as a single loan secured by a first lien for the purposes of determining the loan-to-value ratio and assigning a risk weight.

⁴⁶Loans that qualify as loans secured by 1- to 4-family residential properties or multifamily residential properties are listed in the instructions to the FR Y-9C Report. In addition, for risk-based capital purposes, loans secured by 1- to 4-family residential properties include loans to builders with substantial project equity for the construction of 1- to 4-family residences that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest money deposits. Such loans to builders will be considered prudently underwritten only if the bank holding company has obtained sufficient documentation that the buyer of the home intends to purchase the home (i.e., has a legally binding written sales contract) and has the ability to obtain a mortgage loan sufficient to purchase the home (i.e., has a firm written commitment for permanent financing of the home upon completion).

⁴⁷Residential property loans that do not meet all the specified criteria or that are made for the purpose of speculative property development are placed in the 100 percent risk category.

⁴⁸Prudent underwriting standards include a conservative ratio of the current loan balance to the value of the property. In the case of a loan secured by multifamily residential property, the loan-to-value ratio is not conservative if it exceeds 80 percent (75 percent

forming in accordance with their original terms; and not be 90 days or more past due or carried in nonaccrual status. The following additional criteria must also be applied to a loan secured by a multifamily residential property that is included in this category: all principal and interest payments on the loan must have been made on time for at least the year preceding placement in this category, or in the case where the existing property owner is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placement in this category; amortization of the principal and interest must occur over a period of not more than 30 years and the minimum original maturity for repayment of principal must not be less than 7 years; and the annual net operating income (before debt service) generated by the property during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate) or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution. Also included in this category are privately-issued mortgage-backed securities provided that:

(1) The structure of the security meets the criteria described in section III(B)(3) above;

(2) if the security is backed by a pool of conventional mortgages, on 1- to 4-family residential or multifamily residential properties, each underlying mortgage meets the criteria described above in this section for eligibility for the 50 percent risk category at the time the pool is originated;

(3) If the security is backed by privately-issued mortgage-backed securities, each underlying security qualifies for the 50 percent risk category; and

(4) If the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due. Privately-

if the loan is based on a floating interest rate). Prudent underwriting standards also dictate that a loan-to-value ratio used in the case of originating a loan to acquire a property would not be deemed conservative unless the value is based on the lower of the acquisition cost of the property or appraised (or if appropriate, evaluated) value. Otherwise, the loan-to-value ratio generally would be based upon the value of the property as determined by the most current appraisal, or if appropriate, the most current evaluation. All appraisals must be made in a manner consistent with the Federal banking agencies' real estate appraisal regulations and guidelines and with the banking organization's own appraisal guidelines.

issued mortgage-backed securities that do not meet these criteria or that do not qualify for a lower risk weight are generally assigned to the 100 percent risk category.

Also assigned to this category are *revenue* (non-general obligation) bonds or similar obligations, including loans and leases, that are obligations of states or other political subdivisions of the U.S. (for example, municipal revenue bonds) or other countries of the OECD-based group, but for which the government entity is committed to repay the debt with revenues from the specific projects financed, rather than from general tax funds.

Credit equivalent amounts of derivative contracts involving standard risk obligors (that is, obligors whose loans or debt securities would be assigned to the 100 percent risk category) are included in the 50 percent category, unless they are backed by collateral or guarantees that allow them to be placed in a lower risk category.

4. *Category 4: 100 percent.* a. All assets not included in the categories above are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

b. This category includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk.⁴⁹ This category includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the organization on acceptances outstanding involving standard risk claims;⁵⁰ investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations,

including stock acquired for debts previously contracted; all stripped mortgage-backed securities and similar instruments; and commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans secured by residential property that qualify for a lower risk weight). This category also includes claims representing capital of a qualifying securities firm.

c. Also included in this category are industrial-development bonds and similar obligations issued under the auspices of states or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest, and all obligations of states or political subdivisions of countries that do not belong to the OECD-based group.

d. The following assets also are assigned a risk weight of 100 percent if they have not been deducted from capital: investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital issued by other banking organizations; and any intangibles, including those that may have been grandfathered into capital.

D. Off-Balance Sheet Items

The face amount of an off-balance sheet item is generally incorporated into risk-weighted assets in two steps. The face amount is first multiplied by a credit conversion factor, except for direct credit substitutes and recourse obligations as discussed in section III.D.1. of this appendix. The resultant credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor or the nature of the collateral.⁵¹ Attachment IV to this appendix A sets forth the conversion factors for various types of off-balance sheet items.

1. Items with a 100 percent conversion factor.

a. Except as otherwise provided in section III.B.3. of this appendix, the full amount of an asset or transaction supported, in whole or in part, by a direct credit substitute or a recourse obligation. Direct credit substitutes and recourse obligations are defined in section III.B.3. of this appendix.

⁵¹ The sufficiency of collateral and guarantees for off-balance-sheet items is determined by the market value of the collateral or the amount of the guarantee in relation to the face amount of the item, except for derivative contracts, for which this determination is generally made in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.B. of this appendix A.

⁴⁹ Such assets include all nonlocal currency claims on, and the portions of claims that are guaranteed by, non-OECD central governments and those portions of local currency claims on, or guaranteed by, non-OECD central governments that exceed the local currency liabilities held by subsidiary depository institutions.

⁵⁰ Customer liabilities on acceptances outstanding involving nonstandard risk claims, such as claims on U.S. depository institutions, are assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks are assigned to the 20 percent risk category appropriate to short-term claims guaranteed by U.S. depository institutions and foreign banks.

b. Sale and repurchase agreements and forward agreements. Forward agreements are legally binding contractual obligations to purchase assets with certain drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,⁴⁹ and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

c. Securities lent by a banking organization are treated in one of two ways, depending upon whether the lender is at risk of loss. If a banking organization, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the transaction is excluded from the risk-based capital calculation. If, alternatively, a banking organization lends its own securities or, acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor, or, if applicable, to any collateral delivered to the lending organization, or the independent custodian acting on the lending organization's behalf. Where a banking organization is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the banking organization, the transaction is deemed to be collateralized by cash on deposit in a subsidiary depository institution for purposes of determining the appropriate risk-weight category, provided that any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and any reinvestment risk associated with that cash collateral is borne by the customer.

d. In the case of direct credit substitutes in which a risk participation⁵³ has been conveyed, the full amount of the assets that are supported, in whole or in part, by the credit enhancement are converted to a credit equivalent amount at 100 percent. However, the *pro rata* share of the credit equivalent amount that has been conveyed through a risk participation is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after considering any relevant guarantees or collateral, or the risk category appropriate to the institution

acquiring the participation.⁵⁴ Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the *pro rata* share of the full amount of the assets supported, in whole or in part, by a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the 20 percent risk category.⁵⁵

e. In the case of direct credit substitutes in which a risk participation has been acquired, the acquiring banking organization's percentage share of the direct credit substitute is multiplied by the full amount of the assets that are supported, in whole or in part, by the credit enhancement and converted to a credit equivalent amount at 100 percent. The credit equivalent amount of an acquisition of a risk participation in a direct credit substitute is assigned to the risk category appropriate to the account party obligor or, if relevant, the nature of the collateral or guarantees.

f. In the case of direct credit substitutes that take the form of a syndication where each banking organization is obligated only for its *pro rata* share of the risk and there is no recourse to the originating banking organization, each banking organization will only include its *pro rata* share of the assets supported, in whole or in part, by the direct credit substitute in its risk-based capital calculation.⁵⁶

2. *Items with a 50 percent conversion factor.* Transaction-related contingencies are converted at 50 percent. Such contingencies include bid bonds, performance bonds, warranties, standby letters of credit related to particular transactions, and performance standby letters of credit, as well as acquisitions of risk participation in performance standby letters of credit. Performance standby letters of credit represent obligations backing the performance of nonfinancial or commercial contracts or undertakings. To the extent

⁵⁴A risk participation in bankers acceptances conveyed to other institutions is also assigned to the risk category appropriate to the institution acquiring the participation or, if relevant, the guarantor or nature of the collateral.

⁵⁵Risk participations with a remaining maturity of over one year that are conveyed to non-OECD banks are to be assigned to the 100 percent risk category, unless a lower risk category is appropriate to the obligor, guarantor, or collateral.

⁵⁶For example, if a banking organization has a 10 percent share of a \$10 syndicated direct credit substitute that provides credit support to a \$100 loan, then the banking organization's \$1 *pro rata* share in the enhancement means that a \$10 *pro rata* share of the loan is included in risk weighted assets.

⁴⁹Forward forward deposits accepted are treated as interest rate contracts.

⁵³That is, a participation in which the originating banking organization remains liable to the beneficiary for the full amount of the direct credit substitute if the party that has acquired the participation fails to pay when the instrument is drawn.

permitted by law or regulation, performance standby letters of credit include arrangements backing, among other things, sub-contractors' and suppliers' performance, labor and materials contracts, and construction bids.

The unused portion of commitments with an *original* maturity exceeding one year, including underwriting commitments, and commercial and consumer credit commitments also are converted at 50 percent. Original maturity is defined as the length of time between the date the commitment is issued and the earliest date on which: (1) The banking organization can, at its option, unconditionally (without cause) cancel the commitment;⁵⁷ and (2) the banking organization is scheduled to (and as a normal practice actually does) review the facility to determine whether or not it should be extended. Such reviews must continue to be conducted at least annually for such a facility to qualify as a short-term commitment.

Commitments are defined as any legally binding arrangements that obligate a banking organization to extend credit in the form of loans or leases; to purchase loans, securities, or other assets; or to participate in loans and leases. They also include overdraft facilities, revolving credit, home equity and mortgage lines of credit, and similar transactions. Normally, commitments involve a written contract or agreement and a commitment fee, or some other form of consideration. Commitments are included in weighted risk assets regardless of whether they contain "material adverse change" clauses or other provisions that are intended to relieve the issuer of its funding obligation under certain conditions. In the case of commitments structured as syndications, where the banking organization is obligated solely for its *pro rata* share, only the banking organization's proportional share of the syndicated commitment is taken into account in calculating the risk-based capital ratio.

Facilities that are unconditionally cancellable (without cause) at any time by the banking organization are not deemed to be commitments, provided the banking organization makes a separate credit decision before each drawing under the facility. Commitments with an original maturity of one year or less are deemed to involve low risk and, therefore, are not assessed a capital charge. Such short-term commitments are

defined to include the unused portion of lines of credit on retail credit cards and related plans (as defined in the instructions to the FR Y-9C Report) if the banking organization has the unconditional right to cancel the line of credit at any time, in accordance with applicable law.

Once a commitment has been converted at 50 percent, any portion that has been conveyed to U.S. depository institutions or OECD banks as participations in which the originating banking organization retains the full obligation to the borrower if the participating bank fails to pay when the instrument is drawn, is assigned to the 20 percent risk category. This treatment is analogous to that accorded to conveyances of risk participations in standby letters of credit. The acquisition of a participation in a commitment by a banking organization is converted at 50 percent and assigned to the risk category appropriate to the account party obligor or, if relevant, the nature of the collateral or guarantees.

Revolving underwriting facilities (RUFs), note issuance facilities (NIFs), and other similar arrangements also are converted at 50 percent regardless of maturity. These are facilities under which a borrower can issue on a revolving basis short-term paper in its own name, but for which the underwriting organizations have a legally binding commitment either to purchase any notes the borrower is unable to sell by the roll-over date or to advance funds to the borrower.

3. *Items with a 20 percent conversion factor.* Short-term, self-liquidating trade-related contingencies which arise from the movement of goods are converted at 20 percent. Such contingencies generally include commercial letters of credit and other documentary letters of credit collateralized by the underlying shipments.

4. *Items with a zero percent conversion factor.* These include unused portions of commitments with an original maturity of one year or less, or which are unconditionally cancellable at any time, provided a separate credit decision is made before each drawing under the facility. Unused portions of lines of credit on retail credit cards and related plans are deemed to be short-term commitments if the banking organization has the unconditional right to cancel the line of credit at any time, in accordance with applicable law.

E. *Derivative Contracts (Interest Rate, Exchange Rate, Commodity- (including precious metals) and Equity-Linked Contracts)*

1. *Scope.* Credit equivalent amounts are computed for each of the following off-balance-sheet derivative contracts:

a. *Interest Rate Contracts.* These include single currency interest rate swaps, basis swaps, forward rate agreements, interest

⁵⁷In the case of consumer home equity or mortgage lines of credit secured by liens on 1-4 family residential properties, the bank is deemed able to unconditionally cancel the commitment for the purpose of this criterion if, at its option, it can prohibit additional extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by relevant Federal law.

rate options purchased (including caps, collars, and floors purchased), and any other instrument linked to interest rates that gives rise to similar credit risks (including when-issued securities and forward forward deposits accepted).

b. Exchange Rate Contracts. These include cross-currency interest rate swaps, forward foreign exchange contracts, currency options purchased, and any other instrument linked to exchange rates that gives rise to similar credit risks.

c. Equity Derivative Contracts. These include equity-linked swaps, equity-linked options purchased, forward equity-linked contracts, and any other instrument linked to equities that gives rise to similar credit risks.

d. Commodity (including precious metal) Derivative Contracts. These include commodity-linked swaps, commodity-linked options purchased, forward commodity-linked contracts, and any other instrument linked to commodities that gives rise to similar credit risks.

e. Exceptions. Exchange rate contracts with an original maturity of fourteen or fewer calendar days and derivative contracts traded on exchanges that require daily receipt and payment of cash variation margin may be excluded from the risk-based ratio calculation. Gold contracts are accorded the same treatment as exchange rate contracts except that gold contracts with an original maturity of fourteen or fewer calendar days are included in the risk-based ratio calculation.

tion. Over-the-counter options purchased are included and treated in the same way as other derivative contracts.

2. *Calculation of credit equivalent amounts.* a. The credit equivalent amount of a derivative contract that is not subject to a qualifying bilateral netting contract in accordance with section III.E.3. of this appendix A is equal to the sum of (i) the current exposure (sometimes referred to as the replacement cost) of the contract; and (ii) an estimate of the potential future credit exposure of the contract.

b. The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is equal to that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract and should reflect changes in underlying rates, prices, and indices, as well as counterparty credit quality.

c. The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit conversion factor. Banking organizations should use, subject to examiner review, the effective rather than the apparent or stated notional amount in this calculation. The credit conversion factors are:

CONVERSION FACTORS
[In percent]

Remaining maturity	Interest rate	Exchange rate and gold	Equity	Commodity, excluding precious metals	Precious metals, except gold
One year or less	0.0	1.0	6.0	10.0	7.0
Over one to five years	0.5	5.0	8.0	12.0	7.0
Over five years	1.5	7.5	10.0	15.0	8.0

d. For a contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity is equal to the time until the next reset date. For an interest rate contract with a remaining maturity of more than one year that meets these criteria, the minimum conversion factor is 0.5 percent.

e. For a contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the contract. A derivative contract not included in the definitions of interest rate, exchange rate, equity, or commodity contracts as set forth in section III.E.1. of this appendix

A is subject to the same conversion factors as a commodity, excluding precious metals.

f. No potential future exposure is calculated for a single currency interest rate swap in which payments are made based upon two floating rate indices (a so called floating/floating or basis swap); the credit exposure on such a contract is evaluated solely on the basis of the mark-to-market value.

g. The Board notes that the conversion factors set forth above, which are based on observed volatilities of the particular types of instruments, are subject to review and modification in light of changing volatilities or market conditions.

3. *Netting.* a. For purposes of this appendix A, netting refers to the offsetting of positive and negative mark-to-market values when determining a current exposure to be used in the calculation of a credit equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of derivative contracts is recognized for purposes of calculating the credit equivalent amount provided that:

i. The netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the banking organization would have a claim to receive, or obligation to pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to any of the following events: default, insolvency, liquidation, or similar circumstances.

ii. The banking organization obtains a written and reasoned legal opinion(s) representing that in the event of a legal challenge—including one resulting from default, insolvency, liquidation, or similar circumstances—the relevant court and administrative authorities would find the banking organization's exposure to be the net amount under:

1. The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

2. The law that governs the individual contracts covered by the netting contract; and

3. The law that governs the netting contract.

iii. The banking organization establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in the light of possible changes in relevant law.

iv. The banking organization maintains in its files documentation adequate to support the netting of derivative contracts, including a copy of the bilateral netting contract and necessary legal opinions.

b. A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit equivalent amount.⁵⁸

⁵⁸A walkaway clause is a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract.

c. A banking organization netting individual contracts for the purpose of calculating credit equivalent amounts of derivative contracts represents that it has met the requirements of this appendix A and all the appropriate documents are in the banking organization's files and available for inspection by the Federal Reserve. The Federal Reserve may determine that a banking organization's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable under any one of the bodies of law described in section III.E.3.a.ii. of this appendix A. If such a determination is made, the netting contract may be disqualified from recognition for risk-based capital purposes or underlying individual contracts may be treated as though they are not subject to the netting contract.

d. The credit equivalent amount of contracts that are subject to a qualifying bilateral netting contract is calculated by adding (i) the current exposure of the netting contract (net current exposure) and (ii) the sum of the estimates of potential future credit exposures on all individual contracts subject to the netting contract (gross potential future exposure) adjusted to reflect the effects of the netting contract.⁵⁹

e. The net current exposure is the sum of all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is positive, then the net current exposure is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the net current exposure is zero. The Federal Reserve may determine that a netting contract qualifies for risk-based capital netting treatment even though certain individual contracts included under the netting contract may not qualify. In such instances, the nonqualifying contracts should be treated as individual contracts that are not subject to the netting contract.

f. Gross potential future exposure, or A_{gross} , is calculated by summing the estimates of potential future exposure (determined in accordance with section III.E.2 of this appendix A) for each individual contract subject to the qualifying bilateral netting contract.

g. The effects of the bilateral netting contract on the gross potential future exposure are recognized through the application of a formula that results in an adjusted add-on

⁵⁹For purposes of calculating potential future credit exposure to a netting counterparty for foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency.

amount (A_{net}). The formula, which employs the ratio of net current exposure to gross current exposure (NGR), is expressed as:

$$A_{\text{net}} = (0.4 \times A_{\text{gross}}) + 0.6(\text{NGR} \times A_{\text{gross}})$$

h. The NGR may be calculated in accordance with either the counterparty-by-counterparty approach or the aggregate approach.

i. Under the counterparty-by-counterparty approach, the NGR is the ratio of the net current exposure for a netting contract to the gross current exposure of the netting contract. The gross current exposure is the sum of the current exposures of all individual contracts subject to the netting contract calculated in accordance with section III.E.2. of this appendix A. Net negative mark-to-market values for individual netting contracts with the same counterparty may not be used to offset net positive mark-to-market values for other netting contracts with the same counterparty.

ii. Under the aggregate approach, the NGR is the ratio of the sum of all of the net current exposures for qualifying bilateral netting contracts to the sum of all of the gross current exposures for those netting contracts (each gross current exposure is calculated in the same manner as in section III.E.3.h.i. of this appendix A). Net negative mark-to-market values for individual counterparties may not be used to offset net positive current exposures for other counterparties.

iii. A banking organization must use consistently either the counterparty-by-counterparty approach or the aggregate approach to calculate the NGR. Regardless of the approach used, the NGR should be applied individually to each qualifying bilateral netting contract to determine the adjusted add-on for that netting contract.

i. In the event a netting contract covers contracts that are normally excluded from the risk-based ratio calculation—for example, exchange rate contracts with an original maturity of fourteen or fewer calendar days or instruments traded on exchanges that require daily payment and receipt of cash variation margin—an institution may elect to either include or exclude all mark-to-market values of such contracts when determining net current exposure, provided the method chosen is applied consistently.

4. *Risk Weights.* Once the credit equivalent amount for a derivative contract, or a group of derivative contracts subject to a qualifying bilateral netting contract, has been determined, that amount is assigned to the risk category appropriate to the counterparty, or, if relevant, the guarantor or the nature of any collateral.⁶⁰ However,

the maximum risk weight applicable to the credit equivalent amount of such contracts is 50 percent.

5. *Avoidance of double counting.* a. In certain cases, credit exposures arising from the derivative contracts covered by section III.E. of this appendix A may already be reflected, in part, on the balance sheet. To avoid double counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the derivative instruments covered by these guidelines may need to be excluded from balance sheet assets in calculating a banking organization's risk-based capital ratios.

b. Examples of the calculation of credit equivalent amounts for contracts covered under this section III.E. are contained in Attachment V of this appendix A.

IV. MINIMUM SUPERVISORY RATIOS AND STANDARDS

The interim and final supervisory standards set forth below specify *minimum* supervisory ratios based primarily on broad credit risk considerations. As noted above, the risk-based ratio does not take explicit account of the quality of individual asset portfolios or the range of other types of risks to which banking organizations may be exposed, such as interest rate, liquidity, market or operational risks. For this reason, banking organizations are generally expected to operate with capital positions well above the minimum ratios.

Institutions with high or inordinate levels of risk are expected to operate well above minimum capital standards. Banking organizations experiencing or anticipating significant growth are also expected to maintain capital, including tangible capital positions, well above the minimum levels. For example, most such organizations generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. In all cases, organizations should hold capital commensurate with the level and nature of all of the risks, including the volume and severity of problem loans, to which they are exposed.

Upon adoption of the risk-based framework, any organization that does not meet the interim or final supervisory ratios, or

mined by the market value of the collateral or the amount of the guarantee in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.B. of this appendix A.

⁶⁰ For derivative contracts, sufficiency of collateral or guarantees is generally deter-

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whose capital is otherwise considered inadequate, is expected to develop and implement a plan acceptable to the Federal Reserve for achieving an adequate level of capital consistent with the provisions of these guidelines or with the special circumstances affecting the individual organization. In addition, such organizations should avoid any actions, including increased risk-taking or unwarranted expansion, that would lower or further erode their capital positions.

A. Minimum Risk-Based Ratio After Transition Period

As reflected in Attachment VI, by year-end 1992, all bank holding companies⁶¹ should meet a minimum ratio of qualifying total capital to weighted risk assets of 8 percent, of which at least 4.0 percentage points should be in the form of Tier 1 capital. For purposes of section IV.A., Tier 1 capital is defined as the sum of core capital elements less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix. The maximum amount of supplementary capital elements that qualifies as Tier 2 capital is limited to 100 percent of Tier 1 capital. In addition, the combined maximum amount of subordinated debt and intermediate-term preferred stock that qualifies as Tier 2 capital is limited to 50 percent of Tier 1 capital. The maximum amount of the allowance for loan and lease losses that qualifies as Tier 2 capital is limited to 1.25 percent of gross weighted risk assets. Allowances for loan and lease losses in excess of this limit may, of course, be maintained, but would not be included in an organization's total capital. The Federal Reserve will continue to require bank holding companies to maintain reserves at levels fully sufficient to cover losses inherent in their loan portfolios.

Qualifying total capital is calculated by adding Tier 1 capital and Tier 2 capital (limited to 100 percent of Tier 1 capital) and then deducting from this sum certain investments in banking or finance subsidiaries that are not consolidated for accounting or supervisory purposes, reciprocal holdings of banking organizations' capital securities, or other items at the direction of the Federal Reserve. The conditions under which these deductions are to be made and the procedures for making the deductions are discussed above in section II(B).

B. Transition Arrangements

The transition period for implementing the risk-based capital standard ends on Decem-

ber 31, 1992. Initially, the risk-based capital guidelines do not establish a minimum level of capital. However, by year-end 1990, banking organizations are expected to meet a minimum interim target ratio for qualifying total capital to weighted risk assets of 7.25 percent, at least one-half of which should be in the form of Tier 1 capital. For purposes of meeting the 1990 interim target, the amount of loan loss reserves that may be included in capital is limited to 1.5 percent of weighted risk assets and up to 10 percent of an organization's Tier 1 capital may consist of supplementary capital elements. Thus, the 7.25 percent interim target ratio implies a minimum ratio of Tier 1 capital to weighted risk assets of 3.6 percent (one-half of 7.25) and a minimum ratio of core capital elements to weighted risk assets ratio of 3.25 percent (nine-tenths of the Tier 1 capital ratio).

Through year-end 1990, banking organizations have the option of complying with the minimum 7.25 percent year-end 1990 risk-based capital standard, in lieu of the minimum 5.5 percent primary and 6 percent total capital to total assets ratios set forth in appendix B of this part. In addition, as more fully set forth in appendix D to this part, banking organizations are expected to maintain a minimum ratio of Tier 1 capital to total assets during this transition period.

ATTACHMENT I—SAMPLE CALCULATION OF RISK-BASED CAPITAL RATIO FOR BANK HOLDING COMPANIES

Example of a banking organization with \$6,000 in total capital and the following assets and off-balance sheet items:

Balance Sheet Assets:	
Cash	\$5,000
U.S. Treasuries	20,000
Balances at domestic banks	5,000
Loans secured by first liens on 1-4 family residential properties	5,000
Loans to private corporations	65,000
Total Balance Sheet Assets	\$100,000

Off-Balance Sheet Items:	
Standby letters of credit ("SLCs") backing general obligation debt issues of U.S. municipalities ("GOs")	\$10,000
Long-term legally binding commitments to private corporations	20,000
Total Off/Balance Sheet Items	\$30,000

This bank holding company's total capital to *total* assets (leverage) ratio would be: (\$6,000/\$100,000)=6.00%.

To compute the bank holding company's weighted risk assets:

1. Compute the credit equivalent amount of each off-balance sheet ("OBS") item.

based ratios on a consolidated holding company basis, subject to certain terms and conditions.

⁶¹ As noted in section I above, bank holding companies with less than \$150 million in consolidated assets would generally be exempt from the calculation and analysis of risk-

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OBS item	Face value	Conversion factor	Credit equivalent amount
SLCS backing municipal GOs	\$10,000	× 1.00	= \$10,000
Long-term commitments to private corporations	\$20,000	× 0.50	= \$10,000
2. Multiply each balance sheet asset and the credit equivalent amount of each OBS item by the appropriate risk weight.			
0% Category:			
Cash	5,000		
U.S. Treasuries	20,000		
	25,000	× 0	= 0
20% Category:			
Balances at domestic banks	5,000		
Credit equivalent amounts of SLCS backing GOs of U.S. municipalities	10,000		
	15,000	× .20	= \$3,000
50% Category:			
Loans secured by first liens on 1–4 family residential properties	5,000	× .50	= \$2,500
100% Category:			
Loans to private corporations	65,000		
Credit equivalent amounts of long-term commitments to private corporations	10,000		
	\$75,000	× 1.00	= 75,000
Total Risk-weighted Assets			80,500
This bank holding company's ratio of total capital to weighted risk assets (risk-based capital ratio) would be: (\$6,000/\$80,500)=7.45%			

ATTACHMENT II—SUMMARY OF DEFINITION OF QUALIFYING CAPITAL FOR BANK HOLDING COMPANIES*
[Using the Year-End 1992 Standard]

Components	Minimum requirements
CORE CAPITAL (Tier 1)	Must equal or exceed 4% of weighted-risk assets.
Common stockholders' equity	No limit.
Qualifying noncumulative perpetual preferred stock	No limit; bank holding companies should avoid undue reliance on preferred stock in tier 1.
Qualifying cumulative perpetual preferred stock	Limited to 25% of the sum of common stock, qualifying perpetual stock, and minority interests.
Minority interest in equity accounts of consolidated subsidiaries.	Organizations should avoid using minority interests to introduce elements not otherwise qualifying for tier 1 capital.
Less: Goodwill, other intangible assets, credit-enhancing interest-only strips and nonfinancial equity investments required to be deducted from capital ¹	
SUPPLEMENTARY CAPITAL (Tier 2)	Total of tier 2 is limited to 100% of tier 1. ²
Allowance for loan and lease losses	Limited to 1.25% of weighted-risk assets. ²
Perpetual preferred stock	No limit within tier 2.
Hybrid capital instruments and equity contract notes	No limit within tier 2.
Subordinated debt and intermediate-term preferred stock (original weighted average maturity of 5 years or more).	Subordinated debt and intermediate-term preferred stock are limited to 50% of tier 1 ² ; amortized for capital purposes as they approach maturity.
Revaluation reserves (equity and building)	Not included; organizations encouraged to disclose; may be evaluated on a case-by-case basis for international comparisons; and taken into account in making an overall assessment of capital.
DEDUCTIONS (from sum of tier 1 and tier 2)	
Investments in unconsolidated subsidiaries	As a general rule, one-half of the aggregate investments will be deducted from tier 1 capital and one-half from tier 2 capital. ³
Reciprocal holdings of banking organizations' capital securities	
Other deductions (such as other subsidiaries or joint ventures) as determined by supervisory authority.	On a case-by-case basis or as a matter of policy after a formal rulemaking.
TOTAL CAPITAL (tier 1 + tier 2 – deductions)	Must equal or exceed 8% of weighted-risk assets.

¹ Requirements for the deduction of other intangible assets and residual interests are set forth in section II.B.1. of this appendix.

² Amounts in excess of limitations are permitted but do not qualify as capital.

³ A proportionately greater amount may be deducted from tier 1 capital, if the risks associated with the subsidiary so warrant.

* See discussion in section II of the guidelines for a complete description of the requirements for, and the limitations on, the components of qualifying capital.

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ATTACHMENT III—SUMMARY OF RISK WEIGHTS AND RISK CATEGORIES FOR BANK HOLDING COMPANIES

Category 1: Zero Percent

1. Cash (domestic and foreign) held in subsidiary depository institutions or in transit.
2. Balances due from Federal Reserve Banks (including Federal Reserve Bank stock) and central banks in other OECD countries.
3. Direct claims on, and the portions of claims that are unconditionally guaranteed by, the U.S. Treasury and U.S. Government agencies¹ and the central governments of other OECD countries, and local currency claims on, and the portions of local currency claims that are unconditionally guaranteed by, the central governments of non-OECD countries (including the central banks of non-OECD countries), to the extent that subsidiary depository institutions have liabilities booked in that currency.
4. Gold bullion held in the vaults of a subsidiary depository institution or in another's vaults on an allocated basis, to the extent offset by gold bullion liabilities.
5. Claims collateralized by cash on deposit in the subsidiary lending institution or by securities issued or guaranteed by OECD central governments or U.S. government agencies for which a positive margin of collateral is maintained on a daily basis, fully taking into account any change in the bank's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim.

Category 2: 20 Percent

1. Cash items in the process of collection.
2. All claims (long- or short-term) on, and the portions of claims (long- or short-term) that are guaranteed by, U.S. depository institutions and OECD banks.
3. Short-term claims (remaining maturity of one year or less) on, and the portions of short-term claims that are guaranteed by, non-OECD banks.
4. The portions of claims that are conditionally guaranteed by the central governments of OECD countries and U.S. Government agencies, and the portions of local currency claims that are conditionally guaranteed by the central governments of non-OECD countries, to the extent that subsidiary depository institutions have liabilities booked in that currency.

¹For the purpose of calculating the risk-based capital ratio, a U.S. Government agency is defined as an instrumentality of the U.S. Government whose obligations are fully and *explicitly* guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government.

5. Claims on, and the portions of claims that are guaranteed by, U.S. Government-sponsored agencies.²

6. General obligation claims on, and the portions of claims that are guaranteed by the full faith and credit of, local governments and political subdivisions of the U.S. and other OECD local governments.

7. Claims on, and the portions of claims that are guaranteed by, official multilateral lending institutions or regional development banks.

8. The portions of claims that are collateralized³ by cash on deposit in the subsidiary lending institution or by securities issued or guaranteed by the U.S. Treasury, the central governments of other OECD countries, and U.S. government agencies that do not qualify for the zero percent risk-weight category, or that are collateralized by securities issued or guaranteed by U.S. government-sponsored agencies.

9. The portions of claims that are collateralized³ by securities issued by official multilateral lending institutions or regional development banks.

10. Certain privately-issued securities representing indirect ownership of mortgage-backed U.S. Government agency or U.S. Government-sponsored agency securities.

11. Investments in shares of a fund whose portfolio is permitted to hold only securities that would qualify for the zero or 20 percent risk categories.

12. Claims on, and claims guaranteed by, qualifying securities firms incorporated in the United States or other member of the OECD-based group of countries provided that:

- a. The qualifying securities firm has a rating in one of the top three investment grade rating categories from a nationally recognized statistical rating organization; or

- b. The claim is guaranteed by a qualifying securities firm's parent company with such a rating.

13. Certain collateralized claims on qualifying securities firms in the United States or other member of the OECD-based group of countries, without regard to satisfaction of the rating standard, provided that the claim arises under a contract that:

- a. Is a reverse repurchase/ repurchase agreement or securities lending/borrowing transaction executed under standard industry documentation;

²For the purpose of calculating the risk-based capital ratio, a U.S. Government-sponsored agency is defined as an agency originally established or chartered to serve public purposes specified by the U.S. Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government.

³The extent of collateralization is determined by current market value.

- b. Is collateralized by liquid and readily marketable debt or equity securities;
- c. Is marked to market daily;
- d. Is subject to a daily margin maintenance requirement under the standard industry documentation; and
- e. Can be liquidated, terminated, or accelerated immediately in bankruptcy or similar proceeding, and the security or collateral agreement will not be stayed or avoided, under applicable law of the relevant jurisdiction.

Category 3: 50 Percent

1. Loans fully secured by first liens on 1- to 4-family residential properties or on multifamily residential properties that have been made in accordance with prudent underwriting standards, that are performing in accordance with their original terms, that are not past due or in nonaccrual status, and that meet other qualifying criteria, and certain privately-issued mortgage-backed securities representing indirect ownership of such loans. (Loans made for speculative purposes are excluded.)
2. Revenue bonds or similar claims that are obligations of U.S. state or local governments, or other OECD local governments, but for which the government entity is committed to repay the debt only out of revenues from the facilities financed.
3. Credit equivalent amounts of interest rate and foreign exchange rate related contracts, except for those assigned to a lower risk category.

Category 4: 100 Percent

1. All other claims on private obligors.
2. Claims on, or guaranteed by, non-OECD foreign banks with a remaining maturity exceeding one year.
3. Claims on, or guaranteed by, non-OECD central governments that are not included in item 3 of Category 1 of item 4 of Category 2; all claims on non-OECD state or local governments.
4. Obligations issued by U.S. state or local governments, or other OECD local governments (including industrial development authorities and similar entities), repayable solely by a private party or enterprise.
5. Premises, plant, and equipment; other fixed assets; and other real estate owned.
6. Investments in any unconsolidated subsidiaries, joint ventures, or associated companies—if not deducted from capital.
7. Instruments issued by other banking organizations that qualify as capital—if not deducted from capital.
8. Claims on commercial firms owned by a government.
9. All other assets, including any intangible assets that are not deducted from capital.

ATTACHMENT IV—CREDIT CONVERSION FACTORS FOR OFF-BALANCE-SHEET ITEMS FOR BANK HOLDING COMPANIES

100 Percent Conversion Factor

1. Direct credit substitutes. (These include general guarantees of indebtedness and all guarantee-type instruments, including standby letters of credit backing the financial obligations of other parties.)
2. Risk participations in bankers acceptances and direct credit substitutes, such as standby letters of credit.
3. Sale and repurchase agreements and assets sold with recourse that are not included on the balance sheet.
4. Forward agreements to purchase assets, including financing facilities, on which drawdown is certain.
5. Securities lent for which the banking organization is at risk.

50 Percent Conversion Factor

1. Transaction-related contingencies. (These include bid-bonds, performance bonds, warranties, and standby letters of credit backing the nonfinancial performance of other parties.)
2. Unused portions of commitments with an original maturity exceeding one year, including underwriting commitments and commercial credit lines.
3. Revolving underwriting facilities (RUFs), note issuance facilities (NIFs), and similar arrangements.

20 Percent Conversion Factor

Short-term, self-liquidating trade-related contingencies, including commercial letters of credit.

Zero Percent Conversion Factor

Unused portions of commitments with an original maturity of one year or less, or which are unconditionally cancellable at any time, provided a separate credit decision is made before each drawing.

Credit Conversion for Derivative Contracts

1. The credit equivalent amount of a derivative contract is the sum of the current credit exposure of the contract and an estimate of potential future increases in credit exposure. The current exposure is the positive mark-to-market value of the contract (or zero if the mark-to-market value is zero or negative). For derivative contracts that are subject to a qualifying bilateral netting contract, the current exposure is, generally, the net sum of the positive and negative mark-to-market values of the contracts included in the netting contract (or zero if the net sum of the mark-to-market values is zero or negative). The potential future exposure is calculated by multiplying the effective notional amount of a contract by one of the

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following credit conversion factors, as appropriate:

CONVERSION FACTORS [In percent]

Remaining maturity	Interest rate	Exchange rate and gold	Equity	Commodity, excluding precious metals	Precious metals, except gold
One year or less	0.0	1.0	6.0	10.0	7.0
Over one to five years	0.5	5.0	8.0	12.0	7.0
Over five years	1.5	7.5	10.0	15.0	8.0

For contracts subject to a qualifying bilateral netting contract, the potential future exposure is, generally, the sum of the individual potential future exposures for each contract included under the netting contract adjusted by the application of the following formula:

$$A_{\text{net}} = (0.4 \times A_{\text{gross}}) + 0.6(\text{NGR} \times A_{\text{gross}})$$

NGR is the ratio of net current exposure to gross current exposure.

2. No potential future exposure is calculated for single currency interest rate

swaps in which payments are made based upon two floating indices, that is, so called floating/floating or basis swaps. The credit exposure on these contracts is evaluated solely on the basis of their mark-to-market value. Exchange rate contracts with an original maturity of fourteen or fewer days are excluded. Instruments traded on exchanges that require daily receipt and payment of cash variation margin are also excluded.

ATTACHMENT V—CALCULATING CREDIT EQUIVALENT AMOUNTS FOR DERIVATIVE CONTRACTS

Type of Contract	Notional principal amount	Conversion factor	Potential exposure (dollars)	Mark-to-market	Current exposure (dollars)	Credit equivalent amount
(1) 120-day forward foreign exchange	5,000,000	.01	50,000	100,000	100,000	150,000
(2) 4-year forward foreign exchange	6,000,000	.05	300,000	– 120,000	0	300,000
(3) 3-year single-currency fixed & floating interest rate swap	10,000,000	.005	50,000	200,000	200,000	250,000
(4) 6-month oil swap	10,000,000	.10	1,000,000	– 250,000	0	1,000,000
(5) 7-year cross-currency floating & floating interest rate swap	20,000,000	.075	1,500,000	– 1,500,000	0	1,500,000
Total			2,900,000	+	300,000	3,200,000

a. If contracts (1) through (5) above are subject to a qualifying bilateral netting contract, then the following applies:

Contract	Potential future exposure	Net current exposure	Credit equivalent amount
(1)	50,000	.....	.....
(2)	300,000	.....	.....
(3)	50,000	.....	.....
(4)	1,000,000	.....	.....
(5)	1,500,000	.....	.....
Total	2,900,000	+0	2,900,000

Note: The total of the mark-to-market values from the first table is –\$1,370,000. Since this is a negative amount the net current exposure is zero.

b. To recognize the effects of bilateral netting on potential future exposure the following formula applies:

$$A_{\text{net}} = (0.4 \times A_{\text{gross}}) + 0.6(\text{NGR} \times A_{\text{gross}})$$

c. In the above example, where the net current exposure is zero, the credit equivalent amount would be calculated as follows:

$$\text{NGR} = 0 = (0/300,000)$$

$$A_{\text{net}} = (0.4 \times \$2,900,000) + .6(0 \times \$2,900,000)$$

$$A_{\text{net}} = \$1,160,000$$

The credit equivalent amount is \$1,160,000 + 0 = \$1,160,000.

d. If the net current exposure was a positive number, for example \$200,000, the credit equivalent would be calculated as follows:

$$\text{NGR} = .67 = (\$200,000/\$300,000)$$

$$A_{\text{net}} = (0.4 \times \$2,900,000) + 0.6(.67 \times \$2,900,000)$$

$$A_{\text{net}} = \$2,325,800$$

The credit equivalent amount would be
 $\$2,325,800 + \$200,000 = \$2,525,800$.

ATTACHMENT VI—SUMMARY

	Transitional arrangements for bank holding companies		Final arrangement—Year-end 1992
	Initial	Year-end 1990	
1. Minimum standard of total capital to weighted risk assets.	None	7.25%	8.0%.
2. Definition of Tier 1 capital ...	Common equity, qualifying cum. and noncum. perpetual preferred stock, ¹ and minority interests, <i>plus</i> supplementary elements, ² <i>less</i> goodwill. ³ .	Common equity, qualifying cum. and noncum. perpetual preferred stock, ¹ and minority interests, <i>plus</i> supplementary elements, ⁴ <i>less</i> goodwill. ³ .	Common equity, qualifying noncumulative and cumulative perpetual preferred stock, ¹ and minority interests <i>less</i> goodwill and other intangible assets required to be deducted from capital. ³
3. Minimum standard of Tier 1 capital to weighted risk assets.	None	3.625%	4.0%.
4. Minimum standard of stockholders' equity to weighted risk assets.	None	3.25%	4.0%.
5. Limitations on supplementary capital elements:			
a. Allowance for loan and lease losses.	No limit within Tier 2	1.5% of weighted risk assets	1.25% of weighted risk assets.
b. Perpetual preferred stock.	No limit within Tier 2	No limit within Tier 2	No limit within Tier 2.
c. Hybrid capital instruments, perpetual debt, and mandatory convertibles.	No limit within Tier 2	No limit within Tier 2	No limit within Tier 2.
d. Subordinated debt and intermediate term preferred stock.	Combined maximum of 50% of Tier 1.	Combined maximum of 50% of Tier 1.	Combined maximum of 50% of Tier 1.
e. Total qualifying Tier 2 capital.	May not exceed Tier 1 capital	May not exceed Tier 1 capital	May not exceed Tier 1 capital.
6. Definition of total capital	Tier 1 <i>plus</i> Tier 2 <i>less</i> : —reciprocal holdings of banking organizations' capital instruments. —investments in unconsolidated subsidiaries. ⁵ .	Tier 1 <i>plus</i> Tier 2 <i>less</i> : —reciprocal holdings of banking organizations' capital instruments. —investments in unconsolidated subsidiaries. ⁵ .	Tier 1 <i>plus</i> Tier 2 <i>less</i> : —reciprocal holdings of banking organizations' capital instruments —investments in unconsolidated subsidiaries. ⁵

¹ Cumulative perpetual preferred stock is limited within tier 1 to 25% of the sum of common stockholders' equity, qualifying perpetual preferred stock, and minority interests.

² Supplementary elements may be included in the Tier 1 up to 25% of the sum of Tier 1 plus goodwill.

³ Requirements for the deduction of other intangible assets are set forth in section II.B.1.b. of this appendix.

⁴ Supplementary elements may be included in Tier 1 up to 10% of the sum of Tier 1 plus goodwill.

⁵ As a general rule, one-half (50%) of the aggregate amount of investments will be deducted from Tier 1 capital and one-half (50%) from Tier 2 capital. A proportionally greater amount may be deducted from Tier 1 capital if the risks associated with the subsidiary so warrant.

[Reg. Y, 54 FR 4209, Jan. 27, 1989; 54 FR 12531, Mar. 27, 1989, as amended at 55 FR 32832, Aug. 10, 1990; 56 FR 51156, Oct. 10, 1991; 57 FR 2012, Jan. 17, 1992; 57 FR 60720, Dec. 22, 1992; 57 FR 62180, 62182, Dec. 30, 1992; 58 FR 7980, 7981, Feb. 11, 1993; 58 FR 68739, Dec. 29, 1993; 59 FR 62993, Dec. 7, 1994; 59 FR 63244, Dec. 8, 1994; 59 FR 65926, Dec. 22, 1994; 60 FR 8182, Feb. 13, 1995; 60 FR 45616, Aug. 31, 1995; 60 FR 46179, 46181, Sept. 5, 1995; 60 FR 39230, 39231, Aug. 1, 1995; 60 FR 66045, Dec. 20, 1995; 61 FR 47372, Sept. 6, 1996; 63 FR 42676, Aug. 10, 1998; 63 FR 46522, Sept. 1, 1998; 63 FR 58621, Nov. 2, 1998; 64 FR 10203, Mar. 2, 1999; 66 FR 59643, Nov. 29, 2001; 66 FR 67074, Dec. 28, 2001; 67 FR 3800, Jan. 25, 2002; 67 FR 16977, Apr. 9, 2002; 67 FR 34991, May 17, 2002; 68 FR 56535, Oct. 1, 2003]

APPENDIX B TO PART 225—CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES AND STATE MEMBER BANKS: LEVERAGE MEASURE

The Board of Governors of the Federal Reserve System has adopted minimum capital ratios and guidelines to provide a framework for assessing the adequacy of the capital of bank holding companies and state member banks (collectively "banking organizations"). The guidelines generally apply to all state member banks and bank holding companies regardless of size and are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board of Governors will review the guidelines from time to time for possible adjustment commensurate with changes in the economy, financial markets, and banking practices. In this regard, the Board has determined that during the transition period through year-end 1990 for implementation of the risk-based capital guidelines contained in appendix A to this part and in appendix A to part 208, a banking organization may choose to fulfill the requirements of the guidelines relating capital to total assets contained in this Appendix in one of two manners. Until year-end 1990, a banking organization may choose to conform to either the 5.5 percent and 6 percent minimum primary and total capital standards set forth in this appendix, or the 7.25 percent year-end 1990 minimum risk-based capital standard set forth in appendix A to this part and appendix A to part 208. Those organizations that choose to conform during this period to the 7.25 percent year-end 1990 risk-based capital standard will be deemed to be in compliance with the capital adequacy guidelines set forth in this appendix.

Two principal measurements of capital are used—the primary capital ratio and the total capital ratio. The definitions of primary and total capital for banks and bank holding companies and formulas for calculating the capital ratios are set forth below in the definitional sections of these guidelines.

CAPITAL GUIDELINES

The Board has established a minimum level of primary capital to total assets of 5.5 percent and a minimum level of total capital to total assets of 6.0 percent. Generally, banking organizations are expected to operate above the minimum primary and total capital levels. Those organizations whose operations involve or are exposed to high or inordinate degrees of risk will be expected to hold additional capital to compensate for these risks.

In addition, the Board has established the following three zones for total capital for banking organizations of all sizes:

TOTAL CAPITAL RATIO

[In percent]

Zone 1	Above 7.0.
Zone 2	6.0 to 7.0.
Zone 3	Below 6.0.

The capital guidelines assume adequate liquidity and a moderate amount of risk in the loan and investment portfolios and in off-balance sheet activities. The Board is concerned that some banking organizations may attempt to comply with the guidelines in ways that reduce their liquidity or increase risk. Banking organizations should avoid the practice of attempting to meet the guidelines by decreasing the level of liquid assets in relation to total assets. In assessing compliance with the guidelines, the Federal Reserve will take into account liquidity and the overall degree of risk associated with an organization's operations, including the volume of assets exposed to risk.

The Federal Reserve will also take into account the sale of loans or other assets with recourse and the volume and nature of all off-balance sheet risk. Particularly close attention will be directed to risks associated with standby letters of credit and participation in joint venture activities. The Federal Reserve will review the relationship of all on- and off-balance sheet risks to capital and will require those institutions with high or inordinate levels of risk to hold additional primary capital. In addition, the Federal Reserve will continue to review the need for more explicit procedures for factoring on- and off-balance sheet risks into the assessment of capital adequacy.

The capital guidelines apply to both banks and bank holding companies on a consolidated basis.¹ Some banking organizations are engaged in significant nonbanking activities that typically require capital ratios higher than those of commercial banks alone. The Board believes that, as a matter of both safety and soundness and competitive equity, the degree of leverage common in banking should not automatically extend to nonbanking activities. Consequently, in evaluating the consolidated capital positions of banking organizations, the Board is placing

¹The guidelines will apply to bank holding companies with less than \$150 million in consolidated assets on a bank-only basis unless:

(1) The holding company or any nonbank subsidiary is engaged directly or indirectly in any nonbank activity involving significant leverage or

(2) The holding company or any nonbank subsidiary has outstanding significant debt held by the general public. Debt held by the general public is defined to mean debt held by parties other than financial institutions, officers, directors, and controlling shareholders of the banking organization or their related interests.

greater weight on the building-block approach for assessing capital requirements. This approach generally provides that nonbank subsidiaries of a banking organization should maintain levels of capital consistent with the levels that have been established by industry norms or standards, by Federal or State regulatory agencies for similar firms that are not affiliated with banking organizations, or that may be established by the Board after taking into account risk factors of a particular industry. The assessment of an organization's consolidated capital adequacy must take into account the amount and nature of all nonbank activities, and an institution's consolidated capital position should at least equal the sum of the capital requirements of the organization's bank and nonbank subsidiaries as well as those of the parent company.

SUPERVISORY ACTION

The nature and intensity of supervisory action will be determined by an organization's compliance with the required minimum primary capital ratio as well as by the zone in which the company's total capital ratio falls. Banks and bank holding companies with primary capital ratios below the 5.5 percent minimum will be considered undercapitalized unless they can demonstrate clear extenuating circumstances. Such banking organizations will be required to submit an acceptable plan for achieving compliance with the capital guidelines and will be subject to denial of applications and appropriate supervisory enforcement actions.

The zone in which an organization's total capital ratio falls will normally trigger the following supervisory responses, subject to qualitative analysis:

For institutions operating in Zone 1, the Federal Reserve will:

- Consider that capital is generally adequate if the primary capital ratio is acceptable to the Federal Reserve and is above the 5.5 percent minimum.

For institutions operating in Zone 2, the Federal Reserve will:

- Pay particular attention to financial factors, such as asset quality, liquidity, off-balance sheet risk, and interest rate risk, as they relate to the adequacy of capital. If these areas are deficient and the Federal Reserve concludes capital is not fully adequate, the Federal Reserve will intensify its monitoring and take appropriate supervisory action.

For institutions operating in Zone 3, the Federal Reserve will:

- Consider that the institution is undercapitalized, absent clear extenuating circumstances;
- Require the institution to submit a comprehensive capital plan, acceptable to the

Federal Reserve, that includes a program for achieving compliance with the required minimum ratios within a reasonable time period; and

- Institute appropriate supervisory and/or administrative enforcement action, which may include the issuance of a capital directive or denial of applications, unless a capital plan acceptable to the Federal Reserve has been adopted by the institution.

TREATMENT OF INTANGIBLE ASSETS FOR THE PURPOSE OF ASSESSING THE CAPITAL ADEQUACY OF BANK HOLDING COMPANIES AND STATE MEMBER BANKS

In considering the treatment of intangible assets for the purpose of assessing capital adequacy, the Federal Reserve recognizes that the determination of the future benefits and useful lives of certain intangible assets may involve a degree of uncertainty that is not normally associated with other banking assets. Supervisory concern over intangible assets derives from this uncertainty and from the possibility that, in the event an organization experiences financial difficulties, such assets may not provide the degree of support generally associated with other assets. For this reason, the Federal Reserve will carefully review the level and specific character of intangible assets in evaluating the capital adequacy of state member banks and bank holding companies.

The Federal Reserve recognizes that intangible assets may differ with respect to predictability of any income stream directly associated with a particular asset, the existence of a market for the asset, the ability to sell the asset, or the reliability of any estimate of the asset's useful life. Certain intangible assets have predictable income streams and objectively verifiable values and may contribute to an organization's profitability and overall financial strength. The value of other intangibles, such as goodwill, may involve a number of assumptions and may be more subject to changes in general economic circumstances or to changes in an individual institution's future prospects. Consequently, the value of such intangible assets may be difficult to ascertain. Consistent with prudent banking practices and the principle of the diversification of risks, banking organizations should avoid excessive balance sheet concentration in any category or related categories of intangible assets.

Bank Holding Companies

While the Federal Reserve will consider the amount and nature of all intangible assets, those holding companies with aggregate intangible assets in excess of 25 percent of tangible primary capital (i.e., stated primary capital less all intangible assets) or those institutions with lesser, although still significant, amounts of goodwill will be subject to

close scrutiny. For the purpose of assessing capital adequacy, the Federal Reserve may, on a case-by-case basis, make adjustments to an organization's capital ratios based upon the amount of intangible assets in excess of the 25 percent threshold level or upon the specific character of the organization's intangible assets in relation to its overall financial condition. Such adjustments may require some organizations to raise additional capital.

The Board expects banking organizations (including state member banks) contemplating expansion proposals to ensure that pro forma capital ratios exceed the minimum capital levels without significant reliance on intangibles, particularly goodwill. Consequently, in reviewing acquisition proposals, the Board will take into consideration both the stated primary capital ratio (that is, the ratio without any adjustment for intangible assets) and the primary capital ratio after deducting intangibles. In acting on applications, the Board will take into account the nature and amount of intangible assets and will, as appropriate, adjust capital ratios to include certain intangible assets on a case-by-case basis.

State Member Banks

State member banks with intangible assets in excess of 25 percent of intangible primary capital will be subject to close scrutiny. In addition, for the purpose of calculating capital ratios of state member banks, the Federal Reserve will deduct goodwill from primary capital and total capital. The Federal Reserve may, on a case-by-case basis, make further adjustments to a bank's capital ratios based on the amount of intangible assets (aside from goodwill) in excess of the 25 percent threshold level or on the specific character of the bank's intangible assets in relation to its overall financial condition. Such adjustments may require some banks to raise additional capital.

In addition, state member banks and bank holding companies are expected to review periodically the value at which intangible assets are carried on their balance sheets to determine whether there has been any impairment of value or whether changing circumstances warrant a shortening of amortization periods. Institutions should make appropriate reductions in carrying values and amortization periods in light of this review, and examiners will evaluate the treatment of intangible assets during on-site examinations.

DEFINITION OF CAPITAL TO BE USED IN DETERMINING CAPITAL ADEQUACY OF BANK HOLDING COMPANIES AND STATE MEMBER BANKS

Primary Capital Components

The components of primary capital are:
—Common stock,

- Perpetual preferred stock (preferred stock that does not have a stated maturity date and that may not be redeemed at the option of the holder),
- Surplus (excluding surplus relating to limited-life preferred stock),
- Undivided profits,
- Contingency and other capital reserves,
- Mandatory convertible instruments,²
- Allowance for possible loan and lease losses (exclusive of allocated transfer risk reserves),
- Minority interest in equity accounts of consolidated subsidiaries,
- Perpetual debt instruments (for bank holding companies but not for state member banks).

Limits on Certain Forms of Primary Capital

Bank Holding Companies. The maximum composite amount of mandatory convertible securities, perpetual debt, and perpetual preferred stock that may be counted as primary capital for bank holding companies is limited to 33.3 percent of all primary capital, including these instruments. Perpetual preferred stock issued prior to November 20, 1985 (or determined by the Federal Reserve to be in the process of being issued prior to that date), shall continue to be included as primary capital.

The maximum composite amount of mandatory convertible securities and perpetual debt that may be counted as primary capital for bank holding companies is limited to 20 percent of all primary capital, including these instruments. The maximum amount of equity commitment notes (a form of mandatory convertible securities) that may be counted as primary capital for a bank holding company is limited to 10 percent of all primary capital, including mandatory convertible securities. Amounts outstanding in excess of these limitations may be counted as secondary capital provided they meet the requirements of secondary capital instruments.

State Member Banks. The composite limitations on the amount of mandatory convertible securities and perpetual preferred stock (perpetual debt is not primary capital for state member banks) that may serve as primary capital for bank holding companies shall not be applied formally to state member banks, although the Board shall determine appropriate limits for these forms of primary capital on a case-by-case basis.

The maximum amount of mandatory convertible securities that may be counted as primary capital for state member banks is limited to 16½ percent of all primary capital, including mandatory convertible securities.

²See the definitional section below that lists the criteria for mandatory convertible instruments to qualify as primary capital.

Equity commitment notes, one form of mandatory convertible securities, shall not be included as primary capital for state member banks, except that notes issued by state member banks prior to May 15, 1985, will continue to be included in primary capital. Amounts of mandatory convertible securities in excess of these limitations may be counted as secondary capital if they meet the requirements of secondary capital instruments.

Secondary Capital Components

The components of secondary capital are:

- Limited-life preferred stock (including related surplus) and
- Bank subordinated notes and debentures and unsecured long-term debt of the parent company and its nonbank subsidiaries.

Restrictions Relating to Capital Components

To qualify as primary or secondary capital, a capital instrument should not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices. Examples of such terms are those regarded as unduly interfering with the ability of the bank or holding company to conduct normal banking operations or those resulting in significantly higher dividends or interest payments in the event of a deterioration in the financial condition of the issuer.

The secondary components must meet the following conditions to qualify as capital:

- The instrument must have an original weighted-average maturity of at least seven years.
- The instrument must be unsecured.
- The instrument must clearly state on its face that it is not a deposit and is not insured by a Federal agency.
- Bank debt instruments must be subordinated to claims of depositors.
- For banks only, the aggregate amount of limited-life preferred stock and subordinate debt qualifying as capital may not exceed 50 percent of the amount of the bank's primary capital.

As secondary capital components approach maturity, the banking organization must plan to redeem or replace the instruments while maintaining an adequate overall capital position. Thus, the remaining maturity of secondary capital components will be an important consideration in assessing the adequacy of total capital.

Capital Ratios

The primary and total capital ratios for bank holding companies are computed as follows:

Primary capital ratio:

Primary capital components/Total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)

Total capital ratio:

Primary capital components + Secondary capital components/Total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)

The primary and total capital ratios for state member banks are computed as follows:

Primary capital ratio:

Primary capital components—Goodwill/Average total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)—Goodwill

Total capital ratio:

Primary capital components + Secondary capital components—Goodwill/Average total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)—Goodwill

Generally, period-end amounts will be used to calculate bank holding company ratios. However, the Federal Reserve will discourage temporary balance sheet adjustments or any other “window dressing” practices designed to achieve transitory compliance with the guidelines. Banking organizations are expected to maintain adequate capital positions at all times. Thus, the Federal Reserve will, on a case-by-case basis, use average total assets in the calculation of bank holding company capital ratios whenever this approach provides a more meaningful indication of an individual holding company's capital position.

For the calculation of bank capital ratios, “average total assets” will generally be defined as the quarterly average total assets figure reported on the bank's Report of Condition. If warranted, however, the Federal Reserve may calculate bank capital ratios based upon total assets as of period-end. All other components of the bank's capital ratios will be based upon period-end balances.

CRITERIA FOR DETERMINING THE PRIMARY CAPITAL STATUS OF MANDATORY CONVERTIBLE SECURITIES OF BANK HOLDING COMPANIES AND STATE MEMBER BANKS

Mandatory convertible securities are subordinated debt instruments that are eventually transformed into common or perpetual preferred stock within a specified period of time, not to exceed 12 years. To be counted as primary capital, mandatory convertible securities must meet the criteria set forth below. These criteria cover the two basic types of mandatory convertible securities: “equity contract notes”—securities that obligate the holder to take common or perpetual preferred stock of the issuer in lieu of cash for repayment of principal, and “equity commitment notes”—securities that are redeemable only with the proceeds from the

sale of common or perpetual preferred stock. Both equity commitment notes and equity contract notes qualify as primary capital for bank holding companies, but only equity contract notes qualify as primary capital for banks.

Criteria Applicable to Both Types of Mandatory Convertible Securities

- a. The securities must mature in 12 years or less.
- b. The issuer may redeem securities prior to maturity only with the proceeds from the sale of common or perpetual preferred stock of the bank or bank holding company. Any exception to this rule must be approved by the Federal Reserve. The securities may not be redeemed with the proceeds of another issue of mandatory convertible securities. Nor may the issuer repurchase or acquire its own mandatory convertible securities for resale or reissuance.
- c. Holders of the securities may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.
- d. The securities must be subordinate in right of payment to all senior indebtedness of the issuer. In the event that the proceeds of the securities are reloaned to an affiliate, the loan must be subordinated to the same degree as the original issue.
- e. An issuer that intends to dedicate the proceeds of an issue of common or perpetual preferred stock to satisfy the funding requirements of an issue of mandatory convertible securities (i.e. the requirement to retire or redeem the notes with the proceeds from the issuance of common or perpetual preferred stock) generally must make such a dedication during the quarter in which the new common or preferred stock is issued.³ As a general rule, if the dedication is not made within the prescribed period, then the securities issued may not at a later date be dedicated to the retirement or redemption of the mandatory convertible securities.⁴

³Common or perpetual preferred stock issued under dividend reinvestment plans or issued to finance acquisitions, including acquisitions of business entities, may be dedicated to the retirement or redemption of the mandatory convertible securities. Documentation certified by an authorized agent of the issuer showing the amount of common stock or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.

⁴The dedication procedure is necessary to ensure that the primary capital of the issuer is not overstated. For each dollar of common or perpetual preferred proceeds dedicated to the retirement or redemption of the notes,

Additional Criteria Applicable to Equity Contract Notes

- a. The note must contain a contractual provision (or must be issued with a mandatory stock purchase contract) that requires the holder of the instrument to take the common or perpetual stock of the issuer in lieu of cash in satisfaction of the claim for principal repayment. The obligation of the holder to take the common or perpetual preferred stock of the issuer may be waived if, and to the extent that, prior to the maturity date of the obligation, the issuer sells new common or perpetual preferred stock and dedicates the proceeds to the retirement or redemption of the notes. The dedication generally must be made during the quarter in which the new common or preferred stock is issued.
- b. A stock purchase contract may be separated from a security only if: (1) The holder of the contract provides sufficient collateral⁵ to the issuer, or to an independent trustee for the benefit of the issuer, to assure performance under the contract and (2) the stock purchase contract requires the purchase of common or perpetual preferred stock.

Additional Criteria Applicable to Equity Commitment Notes

- a. The indenture or note agreement must contain the following two provisions:
 1. The proceeds of the sale of common or perpetual preferred stock will be the sole source of repayment for the notes, and the issuer must dedicate the proceeds for the purpose of repaying the notes. (Documentation certified by an authorized agent of the issuer showing the amount of common or

there is a corresponding reduction in the amount of outstanding mandatory securities that may qualify as primary capital. *De minimis* amounts (in relation to primary capital) of common or perpetual preferred stock issued under arrangements in which the amount of stock issued is not predictable, such as dividend reinvestment plans and employee stock option plans (but excluding public stock offerings and stock issued in connection with acquisitions), should be dedicated by no later than the company's fiscal year end.

⁵Collateral is defined as: (1) Cash or certificates of deposit; (2) U.S. government securities that will mature prior to or simultaneous with the maturity of the equity contract and that have a par or maturity value at least equal to the amount of the holder's obligation under the stock purchase contract; (3) standby letters of credit issued by an insured U.S. bank that is not an affiliate of the issuer; or (4) other collateral as may be designated from time to time by the Federal Reserve.

perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.)

2. By the time that one-third of the life of the securities has run, the issuer must have raised and dedicated an amount equal to one-third of the original principal of the securities. By the time that two-thirds of the life of the securities has run, the issuer must have raised and dedicated an amount equal to two-thirds of the original principal of the securities. At least 60 days prior to the maturity of the securities, the issuer must have raised and dedicated an amount equal to the entire original principal of the securities. Proceeds dedicated to redemption or retirement of the notes must come only from the sale of common or perpetual preferred stock.⁶

b. If the issuer fails to meet any of these periodic funding requirements, the Federal Reserve immediately will cease to treat the unfunded securities as primary capital and will take appropriate supervisory action. In addition, failure to meet the funding requirements will be viewed as a breach of a regulatory commitment and will be taken into consideration by the Board in acting on statutory applications.

c. If a security is issued by a subsidiary of a bank or bank holding company, any guarantee of the principal by that subsidiary's parent bank or bank holding company must be subordinate to the same degree as the security issued by the subsidiary and limited to repayment of the principal amount of the security at its final maturity.

CRITERIA FOR DETERMINING THE PRIMARY CAPITAL STATUS OF PERPETUAL DEBT INSTRUMENTS OF BANK HOLDING COMPANIES

1. The instrument must be unsecured and, if issued by a bank, must be subordinated to the claims of depositors.

2. The instrument may not provide the noteholder with the right to demand repayment of principal except in the event of bankruptcy, insolvency, or reorganization. The instrument must provide that nonpayment of interest shall not trigger repayment of the principal of the perpetual debt note or any other obligation of the issuer, nor shall it constitute prima facie evidence of insolvency or bankruptcy.

3. The issuer shall not voluntarily redeem the debt issue without prior approval of the Federal Reserve, except when the debt is converted to, exchanged for, or simultaneously replaced in like amount by an issue

of common or perpetual preferred stock of the issuer or the issuer's parent company.

4. If issued by a bank holding company, a bank subsidiary, or a subsidiary with substantial operations, the instrument must contain a provision that allows the issuer to defer interest payments on the perpetual debt in the event of, and at the same time as the elimination of dividends on all outstanding common or preferred stock of the issuer (or in the case of a guarantee by a parent company at the same time as the elimination of the dividends of the parent company's common and preferred stock). In the case of a nonoperating subsidiary (a funding subsidiary or one formed to issue securities), the deferral of interest payments must be triggered by elimination of dividends by the parent company.

5. If issued by a bank holding company or a subsidiary with substantial operations, the instrument must convert automatically to common or perpetual preferred stock of the issuer when the issuer's retained earnings and surplus accounts become negative. If an operating subsidiary's perpetual debt is guaranteed by its parent, the debt may convert to the shares of the issuer or guarantor and such conversion may be triggered when the issuer's or parent's retained earnings and surplus accounts become negative. If issued by a nonoperating subsidiary of a bank holding company or bank, the instrument must convert automatically to common or preferred stock of the issuer's parent when the retained earnings and surplus accounts of the issuer's parent become negative.

[Reg. Y, 50 FR 16066, Apr. 24, 1985, as amended at 51 FR 40969, Nov. 12, 1986. Redesignated and amended at 54 FR 4209, Jan. 27, 1989; 55 FR 32832, Aug. 10, 1990; 58 FR 474, Jan. 6, 1993]

APPENDIX C TO PART 225—SMALL BANK HOLDING COMPANY POLICY STATEMENT

Policy Statement on Assessment of Financial and Managerial Factors

In acting on applications filed under the Bank Holding Company Act, the Board has adopted, and continues to follow, the principle that bank holding companies should serve as a source of strength for their subsidiary banks. When bank holding companies incur debt and rely upon the earnings of their subsidiary banks as the means of repaying such debt, a question arises as to the probable effect upon the financial condition of the holding company and its subsidiary bank or banks.

The Board believes that a high level of debt at the parent holding company impairs the ability of a bank holding company to provide financial assistance to its subsidiary bank(s) and, in some cases, the servicing requirements on such debt may be a significant drain on the resources of the bank(s).

⁶The funded portions of the securities will be deducted from primary capital to avoid double counting.

For these reasons, the Board has not favored the use of acquisition debt in the formation of bank holding companies or in the acquisition of additional banks. Nevertheless, the Board has recognized that the transfer of ownership of small banks often requires the use of acquisition debt. The Board, therefore, has permitted the formation and expansion of small bank holding companies with debt levels higher than would be permitted for larger holding companies. Approval of these applications has been given on the condition that small bank holding companies demonstrate the ability to service acquisition debt without straining the capital of their subsidiary banks and, further, that such companies restore their ability to serve as a source of strength for their subsidiary banks within a relatively short period of time.

In the interest of continuing its policy of facilitating the transfer of ownership in banks without compromising bank safety and soundness, the Board has, as described below, adopted the following procedures and standards for the formation and expansion of small bank holding companies subject to this policy statement.

1. APPLICABILITY OF POLICY STATEMENT

This policy statement applies only to bank holding companies with *pro forma* consolidated assets of less than \$150 million that: (i) are *not* engaged in any nonbanking activities involving significant leverage¹ and (ii) do *not* have a significant amount of outstanding debt that is held by the general public.

While this policy statement primarily applies to the formation of small bank holding companies, it also applies to existing small bank holding companies that wish to acquire an additional bank or company and to transactions involving changes in control, stock redemptions, or other shareholder transactions.²

2. ONGOING REQUIREMENTS

The following guidelines must be followed on an ongoing basis for all organizations operating under this policy statement.

A. Reduction in parent company leverage: Small bank holding companies are to reduce their parent company debt consistent with the requirement that all debt be retired within 25 years of being incurred. The Board also expects that these bank holding companies reach a debt to equity ratio of .30:1 or less within 12 years of the incurrence of the

debt.³ The bank holding company must also comply with debt servicing and other requirements imposed by its creditors.

B. Capital adequacy: Each insured depository subsidiary of a small bank holding company is expected to be well-capitalized. Any institution that is not well-capitalized is expected to become well-capitalized within a brief period of time.

C. Dividend restrictions: A small bank holding company whose debt to equity ratio is greater than 1.0:1 is not expected to pay corporate dividends until such time as it reduces its debt to equity ratio to 1.0:1 or less and otherwise meets the criteria set forth in §§ 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y.⁴

³The term *debt*, as used in the ratio of debt to equity, means any borrowed funds (exclusive of short-term borrowings that arise out of current transactions, the proceeds of which are used for current transactions), and any securities issued by, or obligations of, the holding company that are the functional equivalent of borrowed funds.

The term *equity*, as used in the ratio of debt to equity, means the total stockholders' equity of the bank holding company as defined in accordance with generally accepted accounting principles. In determining the total amount of stockholders' equity, the bank holding company should account for its investments in the common stock of subsidiaries by the equity method of accounting.

Ordinarily the Board does not view redeemable preferred stock as a substitute for common stock in a small bank holding company. Nevertheless, to a limited degree and under certain circumstances, the Board will consider redeemable preferred stock as equity in the capital accounts of the holding company if the following conditions are met: (1) The preferred stock is redeemable only at the option of the issuer and (2) the debt to equity ratio of the holding company would be at or remain below .30:1 following the redemption or retirement of any preferred stock. Preferred stock that is convertible into common stock of the holding company may be treated as equity.

⁴Dividends may be paid by small bank holding companies with debt to equity at or below 1.0:1 and otherwise meeting the requirements of §§ 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) if the dividends are reasonable in amount, do not adversely affect the ability of the bank holding company to service its debt in an orderly manner, and do not adversely affect the ability of the subsidiary banks to be well-capitalized. It is expected that dividends will be eliminated if the holding company is (1) not reducing its debt consistent with the requirement that the debt to equity ratio be reduced to .30:1 within 12

Continued

¹A parent company that is engaged in significant off-balance sheet activities would generally be deemed to be engaged in activities that involve significant leverage.

²The appropriate Reserve Bank should be contacted to determine the manner in which a specific situation may qualify for treatment under this policy statement.

Small bank holding companies formed before the effective date of this policy statement may switch to a plan that adheres to the intent of this statement provided they comply with the requirements set forth above.

3. CORE REQUIREMENTS FOR ALL APPLICANTS

In assessing applications or notices by organizations subject to this policy statement, the Board will continue to take into account a full range of financial and other information about the applicant, and its current and proposed subsidiaries, including the recent trend and stability of earnings, past and prospective growth, asset quality, the ability to meet debt servicing requirements without placing an undue strain on the resources of the bank(s), and the record and competency of management. In addition, the Board will require applicants to meet the following requirements:

A. Minimum down payment: The amount of acquisition debt should not exceed 75 percent of the purchase price of the bank(s) or company to be acquired. When the owner(s) of the holding company incurs debt to finance the purchase of the bank(s) or company, such debt will be considered acquisition debt even though it does not represent an obligation of the bank holding company, unless the owner(s) can demonstrate that such debt can be serviced without reliance on the resources of the bank(s) or bank holding company.

B. Ability to reduce parent company leverage: The bank holding company must clearly be able to reduce its debt to equity ratio and comply with its loan agreement(s) as set forth in paragraph 2A above.

Failure to meet the criteria in this section would normally result in denial of an application.

4. ADDITIONAL APPLICATION REQUIREMENTS FOR EXPEDITED/WAIVED PROCESSING

A. Expedited notices under §§225.14 and 225.23 of Regulation Y: A small bank holding company proposal will be eligible for the expedited processing procedures set forth in §§225.14 and 225.23 of Regulation Y if the bank holding company is in compliance with the ongoing requirements of this policy statement, the bank holding company meets the core requirements for all applicants noted above, and the following requirements are met:

- i. The parent bank holding company has a *pro forma* debt to equity ratio of 1.0:1 or less.
- ii. The bank holding company meets all of the criteria for expedited action set forth in §§225.14 or 225.23 of Regulation Y.

years of consummation of the proposal or (2) not meeting the requirements of its loan agreement(s).

B. Waiver of stock redemption filing: A small bank holding company will be eligible for the stock redemption filing exception for well-capitalized bank holding companies contained in §225.4(b)(6) if the following requirements are met:

- i. The parent bank holding company has a *pro forma* debt to equity ratio of 1.0:1 or less.
- ii. The bank holding company is in compliance with the ongoing requirements of this policy statement and meets the requirements of §§225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y.

[62 FR 9343, Feb. 28, 1997]

APPENDIX D TO PART 225—CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES: TIER 1 LEVERAGE MEASURE

I. OVERVIEW

a. The Board of Governors of the Federal Reserve System has adopted a minimum ratio of tier 1 capital to total assets to assist in the assessment of the capital adequacy of bank holding companies (banking organizations).¹ The principal objectives of this measure is to place a constraint on the maximum degree to which a banking organization can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital measure.

b. The guidelines apply to consolidated basis to banking holding companies with consolidated assets of \$150 million or more. For bank holding companies with less than \$150 million in consolidated assets, the guidelines will be applied on a bank-only basis unless (i) the parent bank holding company is engaged in nonbank activity involving significant leverage² or (ii) the parent company has a significant amount of outstanding debt that is held by the general public.

c. The tier 1 leverage guidelines are to be used in the inspection and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board will review the guidelines from time to time and will consider the need for possible adjustments in light of any significant changes in the economy, financial markets, and banking practices.

II. THE TIER 1 LEVERAGE RATIO

a. The Board has established a minimum ratio of Tier 1 capital to total assets of 3.0

¹Supervisory ratios that related capital to total assets for state member banks are outlined in Appendix B of this part.

²A parent company that is engaged in significant off balance sheet activities would generally be deemed to be engaged in activities that involve significant leverage.

percent for strong bank holding companies (rated composite "1" under the BOPEC rating system of bank holding companies), and for bank holding companies that have implemented the Board's risk-based capital measure for market risk as set forth in appendices A and E of this part. For all other bank holding companies, the minimum ratio of Tier 1 capital to total assets is 4.0 percent. Banking organizations with supervisory, financial, operational, or managerial weaknesses, as well as organizations that are anticipating or experiencing significant growth, are expected to maintain capital ratios well above the minimum levels. Moreover, higher capital ratios may be required for any bank holding company if warranted by its particular circumstances or risk profile. In all cases, bank holding companies should hold capital commensurate with the level and nature of the risks, including the volume and severity of problem loans, to which they are exposed.

b. A banking organization's tier 1 leverage ratio is calculated by dividing its tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of tier 1 capital as set forth in the risk-based capital guidelines contained in appendix A of this part will be used.³ As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the organization's Con-

solidated Financial Statements (FR Y-9C Report), less goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, are in excess of 100 percent of Tier 1 capital; amounts of nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, are in excess of 25 percent of Tier 1 capital; amounts of credit-enhancing interest-only strips that are in excess of 25 percent of Tier 1 capital; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4 of appendix A of this part; and the amount of the total adjusted carrying value of nonfinancial equity investments that is subject to a deduction from Tier 1 capital.⁴

c. Whenever appropriate, including when an organization is undertaking expansion, seeking to engage in new activities or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an individual organization's tangible tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines an long-standing Board policy and practice with regard to leverage guidelines. Organizations experiencing growth, whether internally or by acquisition, are expected to maintain strong capital position substantially above minimum supervisory levels, without significant reliance on intangible assets.

[Reg. Y, 59 FR 65926, Dec. 22, 1994, as amended by 60 FR 39231, Aug. 1, 1995; 63 FR 30370, June 4, 1998; 63 FR 42676, Aug. 10, 1998; 66 FR 59651, Nov. 29, 2001; 67 FR 3803, Jan. 25, 2002]

APPENDIX E TO PART 225—CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES: MARKET RISK MEASURE

Section 1. Purpose, Applicability, Scope, and Effective Date

(a) *Purpose.* The purpose of this appendix is to ensure that bank holding companies (organizations) with significant exposure to market risk maintain adequate capital to

³Tier 1 capital for banking organizations includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and qualifying cumulative perpetual preferred stock. (Cumulative perpetual preferred stock is limited to 25 percent of Tier 1 capital.) In addition, as a general matter, Tier 1 capital excludes goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, exceed 100 percent of Tier 1 capital; amounts of nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, exceed 25 percent of Tier 1 capital; amounts of credit-enhancing interest-only strips that are in excess of 25 percent of Tier 1 capital; all other identifiable intangible assets; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations; and a percentage of the organization's nonfinancial equity investments. The Federal Reserve may exclude certain other investments in subsidiaries or associated companies as appropriate.

⁴Deductions from Tier 1 capital and other adjustments are discussed more fully in section II.B. of appendix A of this part.

support that exposure.¹ This appendix supplements and adjusts the risk-based capital ratio calculations under appendix A of this part with respect to those organizations.

(b) *Applicability.* (1) This appendix applies to any bank holding company whose trading activity² (on a worldwide consolidated basis) equals:

- (i) 10 percent or more of total assets;³ or
- (ii) \$1 billion or more.

(2) The Federal Reserve may additionally apply this appendix to any bank holding company if the Federal Reserve deems it necessary or appropriate for safe and sound banking practices.

(3) The Federal Reserve may exclude a bank holding company otherwise meeting the criteria of paragraph (b)(1) of this section from coverage under this appendix if it determines the organization meets such criteria as a consequence of accounting, operational, or similar considerations, and the Federal Reserve deems it consistent with safe and sound banking practices.

(c) *Scope.* The capital requirements of this appendix support market risk associated with an organization's covered positions.

(d) *Effective date.* This appendix is effective as of January 1, 1997. Compliance is not mandatory until January 1, 1998. Subject to supervisory approval, a bank holding company may opt to comply with this appendix as early as January 1, 1997.⁴

Section 2. Definitions

For purposes of this appendix, the following definitions apply:

(a) *Covered positions* means all positions in an organization's trading account, and all foreign exchange⁵ and commodity positions,

¹This appendix is based on a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Supervision and endorsed by the Group of Ten Central Bank Governors. The framework is described in a Basle Committee paper entitled "Amendment to the Capital Accord to Incorporate Market Risks," January 1996. Also see modifications issued in September 1997.

²Trading activity means the gross sum of trading assets and liabilities as reported in the bank holding company's most recent quarterly Y-9C Report.

³Total assets means quarter-end total assets as reported in the bank holding company's most recent Y-9C Report.

⁴A bank holding company that voluntarily complies with the final rule prior to January 1, 1998, must comply with all of its provisions.

⁵Subject to supervisory review, a bank may exclude structural positions in foreign currencies from its covered positions.

whether or not in the trading account.⁶ Positions include on-balance-sheet assets and liabilities and off-balance-sheet items. Securities subject to repurchase and lending agreements are included as if still owned by the lender.

(b) *Market risk* means the risk of loss resulting from movements in market prices. Market risk consists of general market risk and specific risk components.

(1) *General market risk* means changes in the market value of covered positions resulting from broad market movements, such as changes in the general level of interest rates, equity prices, foreign exchange rates, or commodity prices.

(2) *Specific risk* means changes in the market value of specific positions due to factors other than broad market movements and includes event and default risk as well as idiosyncratic variations.

(c) *Tier 1* and *Tier 2 capital* are defined in appendix A of this part.

(d) *Tier 3 capital* is subordinated debt that is unsecured; is fully paid up; has an original maturity of at least two years; is not redeemable before maturity without prior approval by the Federal Reserve; includes a lock-in clause precluding payment of either interest or principal (even at maturity) if the payment would cause the issuing organization's risk-based capital ratio to fall or remain below the minimum required under appendix A of this part; and does not contain and is not covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

(e) *Value-at-risk (VAR)* means the estimate of the maximum amount that the value of covered positions could decline due to market price or rate movements during a fixed holding period within a stated confidence level, measured in accordance with section 4 of this appendix.

Section 3. Adjustments to the Risk-Based Capital Ratio Calculations

(a) *Risk-based capital ratio denominator.* An organization subject to this appendix shall calculate its risk-based capital ratio denominator as follows:

(1) *Adjusted risk-weighted assets.* Calculate adjusted risk-weighted assets, which equals risk-weighted assets (as determined in accordance with appendix A of this part), excluding the risk-weighted amounts of all covered positions (except foreign exchange positions outside the trading account and over-the-counter derivative positions)⁷ and

⁶The term trading account is defined in the instructions to the Call Report.

⁷Foreign exchange positions outside the trading account and all over-the-counter derivative positions, whether or not in the

receivables arising from the posting of cash collateral that is associated with securities borrowing transactions to the extent the receivables are collateralized by the market value of the borrowed securities, provided that the following conditions are met:

(i) The transaction is based on securities includable in the trading book that are liquid and readily marketable,

(ii) The transaction is marked to market daily,

(iii) The transaction is subject to daily margin maintenance requirements,

(iv) The transaction is a securities contract for the purposes of section 555 of the Bankruptcy Code (11 U.S.C. 555), a qualified financial contract for the purposes of section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between or among financial institutions for the purposes of sections 401-407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401-4407), or the Board's Regulation EE (12 CFR Part 231).

(2) *Measure for market risk.* Calculate the measure for market risk, which equals the sum of the VAR-based capital charge, the specific risk add-on (if any), and the capital charge for de minimis exposures (if any).

(i) *VAR-based capital charge.* The VAR-based capital charge equals the higher of:

(A) The previous day's VAR measure; or

(B) The average of the daily VAR measures for each of the preceding 60 business days multiplied by three, except as provided in section 4(e) of this appendix;

(ii) *Specific risk add-on.* The specific risk add-on is calculated in accordance with section 5 of this appendix; and

(iii) *Capital charge for de minimis exposure.* The capital charge for de minimis exposure is calculated in accordance with section 4(a) of this appendix.

(3) *Market risk equivalent assets.* Calculate market risk equivalent assets by multiplying the measure for market risk (as calculated in paragraph (a)(2) of this section) by 12.5.

(4) *Denominator calculation.* Add market risk equivalent assets (as calculated in paragraph (a)(3) of this section) to adjusted risk-weighted assets (as calculated in paragraph (a)(1) of this section). The resulting sum is the organization's risk-based capital ratio denominator.

(b) *Risk-based capital ratio numerator.* An organization subject to this appendix shall calculate its risk-based capital ratio numerator by allocating capital as follows:

(1) *Credit risk allocation.* Allocate Tier 1 and Tier 2 capital equal to 8.0 percent of adjusted

risk-weighted assets (as calculated in paragraph (a)(1) of this section).⁸

(2) *Market risk allocation.* Allocate Tier 1, Tier 2, and Tier 3 capital equal to the measure for market risk as calculated in paragraph (a)(2) of this section. The sum of Tier 2 and Tier 3 capital allocated for market risk must not exceed 250 percent of Tier 1 capital allocated for market risk. (This requirement means that Tier 1 capital allocated in this paragraph (b)(2) must equal at least 28.6 percent of the measure for market risk.)

(3) *Restrictions.* (i) The sum of Tier 2 capital (both allocated and excess) and Tier 3 capital (allocated in paragraph (b)(2) of this section) may not exceed 100 percent of Tier 1 capital (both allocated and excess).⁹

(ii) Term subordinated debt (and intermediate-term preferred stock and related surplus) included in Tier 2 capital (both allocated and excess) may not exceed 50 percent of Tier 1 capital (both allocated and excess).

(4) *Numerator calculation.* Add Tier 1 capital (both allocated and excess), Tier 2 capital (both allocated and excess), and Tier 3 capital (allocated under paragraph (b)(2) of this section). The resulting sum is the organization's risk-based capital ratio numerator.

Section 4. Internal Models

(a) *General.* For risk-based capital purposes, a bank holding company subject to this appendix must use its internal model to measure its daily VAR, in accordance with the requirements of this section.¹⁰ The Federal Reserve may permit an organization to use alternative techniques to measure the market risk of de minimis exposures so long

⁸An institution may not allocate Tier 3 capital to support credit risk (as calculated under appendix A of this part).

⁹Excess Tier 1 capital means Tier 1 capital that has not been allocated in paragraphs (b)(1) and (b)(2) of this section. Excess Tier 2 capital means Tier 2 capital that has not been allocated in paragraph (b)(1) and (b)(2) of this section, subject to the restrictions in paragraph (b)(3) of this section.

¹⁰An organization's internal model may use any generally accepted measurement techniques, such as variance-covariance models, historical simulations, or Monte Carlo simulations. However, the level of sophistication and accuracy of an organization's internal model must be commensurate with the nature and size of its covered positions. An organization that modifies its existing modeling procedures to comply with the requirements of this appendix for risk-based capital purposes should, nonetheless, continue to use the internal model it considers most appropriate in evaluating risks for other purposes.

trading account, must be included in the adjusted risk weighted assets as determined in appendix A of this part.

as the techniques adequately measure associated market risk.

(b) *Qualitative requirements.* A bank holding company subject to this appendix must have a risk management system that meets the following minimum qualitative requirements:

(1) The organization must have a risk control unit that reports directly to senior management and is independent from business trading units.

(2) The organization's internal risk measurement model must be integrated into the daily management process.

(3) The organization's policies and procedures must identify, and the organization must conduct, appropriate stress tests and backtests.¹¹ The organization's policies and procedures must identify the procedures to follow in response to the results of such tests.

(4) The organization must conduct independent reviews of its risk measurement and risk management systems at least annually.

(c) *Market risk factors.* The organization's internal model must use risk factors sufficient to measure the market risk inherent in all covered positions. The risk factors must address interest rate risk,¹² equity price risk, foreign exchange rate risk, and commodity price risk.

(d) *Quantitative requirements.* For regulatory capital purposes, VAR measures must meet the following quantitative requirements:

(1) The VAR measures must be calculated on a daily basis using a 99 percent, one-tailed confidence level with a price shock equivalent to a ten-business day movement in rates and prices. In order to calculate VAR measures based on a ten-day price shock, the organization may either calculate ten-day figures directly or convert VAR figures based on holding periods other than ten days to the equivalent of a ten-day holding period (for instance, by multiplying a one-day VAR measure by the square root of ten).

(2) The VAR measures must be based on an historical observation period (or effective observation period for an organization using a weighting scheme or other similar method)

¹¹ Stress tests provide information about the impact of adverse market events on a bank's covered positions. Backtests provide information about the accuracy of an internal model by comparing an organization's daily VAR measures to its corresponding daily trading profits and losses.

¹² For material exposures in the major currencies and markets, modeling techniques must capture spread risk and must incorporate enough segments of the yield curve—at least six—to capture differences in volatility and less than perfect correlation of rates along the yield curve.

of at least one year. The organization must update data sets at least once every three months or more frequently as market conditions warrant.

(3) The VAR measures must include the risks arising from the non-linear price characteristics of options positions and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates or prices. An organization with a large or complex options portfolio must measure the volatility of options positions by different maturities.

(4) The VAR measures may incorporate empirical correlations within and across risk categories, provided that the organization's process for measuring correlations is sound. In the event that the VAR measures do not incorporate empirical correlations across risk categories, then the organization must add the separate VAR measures for the four major risk categories to determine its aggregate VAR measure.

(e) *Backtesting.* (1) Beginning one year after a bank holding company starts to comply with this appendix, it must conduct backtesting by comparing each of its most recent 250 business days' actual net trading profit or loss¹³ with the corresponding daily VAR measures generated for internal risk measurement purposes and calibrated to a one-day holding period and a 99th percentile, one-tailed confidence level.

(2) Once each quarter, the organization must identify the number of exceptions, that is, the number of business days for which the magnitude of the actual daily net trading loss, if any, exceeds the corresponding daily VAR measure.

(3) A bank holding company must use the multiplication factor indicated in Table 1 of this appendix in determining its capital charge for market risk under section 3(a)(2)(i)(B) of this appendix until it obtains the next quarter's backtesting results, unless the Federal Reserve determines that a different adjustment or other action is appropriate.

TABLE 1—MULTIPLICATION FACTOR BASED ON RESULTS OF BACKTESTING

Number of exceptions	Multiplication factor
4 or fewer	3.00
5	3.40
6	3.50
7	3.65
8	3.75
9.	

¹³ Actual net trading profits and losses typically include such things as realized and unrealized gains and losses on portfolio positions as well as fee income and commissions associated with trading activities.

TABLE 1—MULTIPLICATION FACTOR BASED ON RESULTS OF BACKTESTING—Continued

Number of exceptions	Multiplication factor
10 or more	4.00

Section 5. Specific Risk

(a) *Modeled specific risk.* A bank holding company may use its internal model to measure specific risk. If the organization has demonstrated to the Federal Reserve that its internal model measures the specific risk, including event and default risk as well as idiosyncratic variation, of covered debt and equity positions and includes the specific risk measures in the VAR-based capital charge in section 3(a)(2)(i) of this appendix, then the organization has no specific risk add-on for purposes of section 3(a)(2)(ii) of this appendix. The model should explain the historical price variation in the trading portfolio and capture concentration, both magnitude and changes in composition. The model should also be robust to an adverse environment and have been validated through backtesting which assesses whether specific risk is being accurately captured.

(b) *Partially modeled specific risk.* (1) A bank holding company that incorporates specific risk in its internal model but fails to demonstrate to the Federal Reserve that its internal model adequately measures all aspects of specific risk for covered debt and equity positions, including event and default risk, as provided by section 5(a) of this appendix, must calculate its specific risk add-on in accordance with one of the following methods:

(i) If the model is susceptible to valid separation of the VAR measure into a specific risk portion and a general market risk portion, then the specific risk add-on is equal to the previous day's specific risk portion.

(ii) If the model does not separate the VAR measure into a specific risk portion and a general market risk portion, then the specific risk add-on is the sum of the previous day's VAR measures for subportfolios of covered debt and equity positions that contain specific risk.

(2) If a bank holding company models the specific risk of covered debt positions but not covered equity positions (or vice versa), then the bank holding company may determine its specific risk charge for the included positions under section 5(a) or 5(b)(1) of this appendix, as appropriate. The specific risk charge for the positions not included equals the standard specific risk capital charge under paragraph (c) of this section.

(c) *Specific risk not modeled.* If a bank holding company does not model specific risk in accordance with section 5(a) or 5(b) of this appendix, then the organization's specific

risk capital charge shall equal the standard specific risk capital charge, calculated as follows:

(1) *Covered debt positions.* (i) For purposes of this section 5, covered debt positions means fixed-rate or floating-rate debt instruments located in the trading account or instruments located in the trading account with values that react primarily to changes in interest rates, including certain non-convertible preferred stock, convertible bonds, and instruments subject to repurchase and lending agreements. Also included are derivatives (including written and purchased options) for which the underlying instrument is a covered debt instrument that is subject to a non-zero specific risk capital charge.

(A) For covered debt positions that are derivatives, an organization must risk-weight (as described in paragraph (c)(1)(iii) of this section) the market value of the effective notional amount of the underlying debt instrument or index portfolio. Swaps must be included as the notional position in the underlying debt instrument or index portfolio, with a receiving side treated as a long position and a paying side treated as a short position; and

(B) For covered debt positions that are options, whether long or short, an organization must risk-weight (as described in paragraph (c)(1)(iii) of this section) the market value of the effective notional amount of the underlying debt instrument or index multiplied by the option's delta.

(ii) An organization may net long and short covered debt positions (including derivatives) in identical debt issues or indices.

(iii) An organization must multiply the absolute value of the current market value of each net long or short covered debt position by the appropriate specific risk weighting factor indicated in Table 2 of this appendix. The specific risk capital charge component for covered debt positions is the sum of the weighted values.

TABLE 2—SPECIFIC RISK WEIGHTING FACTORS FOR COVERED DEBT POSITIONS

Category	Remaining maturity (contractual)	Weighting factor (in percent)
Government	N/A	0.00
Qualifying	6 months or less	0.25
	Over 6 months to 24 months	1.00
	Over 24 months	1.60
Other	N/A	8.00

(A) The *government* category includes all debt instruments of central governments of

OECD-based countries¹⁴ including bonds, Treasury bills, and other short-term instruments, as well as local currency instruments of non-OECD central governments to the extent the organization has liabilities booked in that currency.

(B) The *qualifying* category includes debt instruments of U.S. government-sponsored agencies, general obligation debt instruments issued by states and other political subdivisions of OECD-based countries, multilateral development banks, and debt instruments issued by U.S. depository institutions or OECD banks that do not qualify as capital of the issuing institution.¹⁵ This category also includes other debt instruments, including corporate debt and revenue instruments issued by states and other political subdivisions of OECD countries, that are:

(1) Rated investment-grade by at least two nationally recognized credit rating services;

(2) Rated investment grade by one nationally recognized credit rating agency and not rated less than investment grade by any other credit rating agency; or

(3) Unrated, but deemed to be of comparable investment quality by the reporting organization and the issuer has instruments listed on a recognized stock exchange, subject to review by the Federal Reserve.

(C) The *other* category includes debt instruments that are not included in the government or qualifying categories.

(2) *Covered equity positions.* (i) For purposes of this section 5, covered equity positions means equity instruments located in the trading account and instruments located in the trading account with values that react primarily to changes in equity prices, including voting or non-voting common stock, certain convertible bonds, and commitments to buy or sell equity instruments. Also included are derivatives (including written or purchased options) for which the underlying is a covered equity position.

(A) For covered equity positions that are derivatives, an organization must risk weight (as described in paragraph (c)(2)(iii) of this section) the market value of the effective notional amount of the underlying equity instrument or equity portfolio. Swaps must be included as the notional position in the underlying equity instrument or index portfolio, with a receiving side treated as a long position and a paying side treated as a short position; and

(B) For covered equity positions that are options, whether long or short, an organization must risk weight (as described in para-

graph (c)(2)(iii) of this section) the market value of the effective notional amount of the underlying equity instrument or index multiplied by the option's delta.

(ii) An organization may net long and short covered equity positions (including derivatives) in identical equity issues or equity indices in the same market.¹⁶

(iii)(A) An organization must multiply the absolute value of the current market value of each net long or short covered equity position by a risk weighting factor of 8.0 percent, or by 4.0 percent if the equity is held in a portfolio that is both liquid and well-diversified.¹⁷ For covered equity positions that are index contracts comprising a well-diversified portfolio of equity instruments, the net long or short position is to be multiplied by a risk weighting factor of 2.0 percent.

(B) For covered equity positions from the following futures-related arbitrage strategies, an organization may apply a 2.0 percent risk weighting factor to one side (long or short) of each equity position with the opposite side exempt from charge, subject to review by the Federal Reserve:

(1) Long and short positions in exactly the same index at different dates or in different market centers; or

(2) Long and short positions in index contracts at the same date in different but similar indices.

(C) For futures contracts on broadly-based indices that are matched by offsetting positions in a basket of stocks comprising the index, an organization may apply a 2.0 percent risk weighting factor to the futures and stock basket positions (long and short), provided that such trades are deliberately entered into and separately controlled, and that the basket of stocks comprises at least 90 percent of the capitalization of the index.

¹⁶An organization may also net positions in depository receipts against an opposite position in the underlying equity or identical equity in different markets, provided that the organization includes the costs of conversion.

¹⁷A portfolio is liquid and well-diversified if: (1) it is characterized by a limited sensitivity to price changes of any single equity issue or closely related group of equity issues held in the portfolio; (2) the volatility of the portfolio's value is not dominated by the volatility of any individual equity issue or by equity issues from any single industry or economic sector; (3) it contains a large number of individual equity positions, with no single position representing a substantial portion of the portfolio's total market value; and (4) it consists mainly of issues traded on organized exchanges or in well-established over-the-counter markets.

¹⁴Organization for Economic Cooperation and Development (OECD)-based countries is defined in appendix A of this part.

¹⁵U.S. government-sponsored agencies, multilateral development banks, and OECD banks are defined in appendix A of this part.

(iv) The specific risk capital charge component for covered equity positions is the sum of the weighted values.

[61 FR 47373, Sept. 6, 1996, as amended at 62 FR 68068, Dec. 30, 1997; 64 FR 19038, Apr. 19, 1999; 65 FR 75859, Dec. 5, 2000]

APPENDIX F TO PART 225—INTERAGENCY GUIDELINES ESTABLISHING STANDARDS FOR SAFEGUARDING CUSTOMER INFORMATION

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I. INTRODUCTION

These Interagency Guidelines Establishing Standards for Safeguarding Customer Information (Guidelines) set forth standards pursuant to sections 501 and 505 of the Gramm-Leach-Bliley Act (15 U.S.C. 6801 and 6805). These Guidelines address standards for developing and implementing administrative, technical, and physical safeguards to protect the security, confidentiality, and integrity of customer information.

A. *Scope.* The Guidelines apply to customer information maintained by or on behalf of bank holding companies and their nonbank subsidiaries or affiliates (except brokers, dealers, persons providing insurance, investment companies, and investment advisors), for which the Board has supervisory authority.

B. *Preservation of Existing Authority.* These Guidelines do not in any way limit the authority of the Board to address unsafe or unsound practices, violations of law, unsafe or unsound conditions, or other practices. The Board may take action under these Guidelines independently of, in conjunction with, or in addition to, any other enforcement action available to the Board.

C. *Definitions.* 1. Except as modified in the Guidelines, or unless the context otherwise requires, the terms used in these Guidelines have the same meanings as set forth in sections 3 and 39 of the Federal Deposit Insurance Act (12 U.S.C. 1813 and 1831p-1).

2. For purposes of the Guidelines, the following definitions apply:

a. *Board of directors*, in the case of a branch or agency of a foreign bank, means the managing official in charge of the branch or agency.

b. *Customer* means any customer of the bank holding company as defined in §216.3(h) of this chapter.

c. *Customer information* means any record containing nonpublic personal information, as defined in §216.3(n) of this chapter, about a customer, whether in paper, electronic, or other form, that is maintained by or on behalf of the bank holding company.

d. *Customer information systems* means any methods used to access, collect, store, use, transmit, protect, or dispose of customer information.

e. *Service provider* means any person or entity that maintains, processes, or otherwise is permitted access to customer information through its provision of services directly to the bank holding company.

f. *Subsidiary* means any company controlled by a bank holding company, except a broker, dealer, person providing insurance, investment company, investment advisor, insured depository institution, or subsidiary of an insured depository institution.

II. STANDARDS FOR SAFEGUARDING CUSTOMER INFORMATION

A. *Information Security Program.* Each bank holding company shall implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the size and complexity of the bank holding company and the nature and scope of its activities. While all parts of the bank holding company are not required to implement a uniform set of policies, all elements of the information security program must be coordinated. A bank holding company also shall ensure that each of its subsidiaries is subject to a comprehensive information security program. The bank holding company may fulfill this requirement either by including a subsidiary within the scope of the bank holding company's comprehensive information security program or by causing the subsidiary to implement a separate comprehensive information security program in accordance with the standards and procedures in sections II and III of this appendix that apply to bank holding companies.

B. *Objectives.* A bank holding company's information security program shall be designed to:

1. Ensure the security and confidentiality of customer information;
2. Protect against any anticipated threats or hazards to the security or integrity of such information; and
3. Protect against unauthorized access to or use of such information that could result

in substantial harm or inconvenience to any customer.

III. DEVELOPMENT AND IMPLEMENTATION OF INFORMATION SECURITY PROGRAM

A. Involve the Board of Directors. The board of directors or an appropriate committee of the board of each bank holding company shall:

1. Approve the bank holding company's written information security program; and
2. Oversee the development, implementation, and maintenance of the bank holding company's information security program, including assigning specific responsibility for its implementation and reviewing reports from management.

B. Assess Risk. Each bank holding company shall:

1. Identify reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems.
2. Assess the likelihood and potential damage of these threats, taking into consideration the sensitivity of customer information.
3. Assess the sufficiency of policies, procedures, customer information systems, and other arrangements in place to control risks.

C. Manage and Control Risk. Each bank holding company shall:

1. Design its information security program to control the identified risks, commensurate with the sensitivity of the information as well as the complexity and scope of the bank holding company's activities. Each bank holding company must consider whether the following security measures are appropriate for the bank holding company and, if so, adopt those measures the bank holding company concludes are appropriate:

a. Access controls on customer information systems, including controls to authenticate and permit access only to authorized individuals and controls to prevent employees from providing customer information to unauthorized individuals who may seek to obtain this information through fraudulent means.

b. Access restrictions at physical locations containing customer information, such as buildings, computer facilities, and records storage facilities to permit access only to authorized individuals;

c. Encryption of electronic customer information, including while in transit or in storage on networks or systems to which unauthorized individuals may have access;

d. Procedures designed to ensure that customer information system modifications are consistent with the bank holding company's information security program;

e. Dual control procedures, segregation of duties, and employee background checks for

employees with responsibilities for or access to customer information;

f. Monitoring systems and procedures to detect actual and attempted attacks on or intrusions into customer information systems;

g. Response programs that specify actions to be taken when the bank holding company suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies; and

h. Measures to protect against destruction, loss, or damage of customer information due to potential environmental hazards, such as fire and water damage or technological failures.

2. Train staff to implement the bank holding company's information security program.

3. Regularly test the key controls, systems and procedures of the information security program. The frequency and nature of such tests should be determined by the bank holding company's risk assessment. Tests should be conducted or reviewed by independent third parties or staff independent of those that develop or maintain the security programs.

D. Oversee Service Provider Arrangements. Each bank holding company shall:

1. Exercise appropriate due diligence in selecting its service providers;

2. Require its service providers by contract to implement appropriate measures designed to meet the objectives of these Guidelines; and

3. Where indicated by the bank holding company's risk assessment, monitor its service providers to confirm that they have satisfied their obligations as required by paragraph D.2. As part of this monitoring, a bank holding company should review audits, summaries of test results, or other equivalent evaluations of its service providers.

E. Adjust the Program. Each bank holding company shall monitor, evaluate, and adjust, as appropriate, the information security program in light of any relevant changes in technology, the sensitivity of its customer information, internal or external threats to information, and the bank holding company's own changing business arrangements, such as mergers and acquisitions, alliances and joint ventures, outsourcing arrangements, and changes to customer information systems.

F. Report to the Board. Each bank holding company shall report to its board or an appropriate committee of the board at least annually. This report should describe the overall status of the information security program and the bank holding company's compliance with these Guidelines. The reports should discuss material matters related to its program, addressing issues such as: risk

assessment; risk management and control decisions; service provider arrangements; results of testing; security breaches or violations and management's responses; and recommendations for changes in the information security program.

G. Implement the Standards.

1. *Effective date.* Each bank holding company must implement an information security program pursuant to these Guidelines by July 1, 2001.

2. *Two-year grandfathering of agreements with service providers.* Until July 1, 2003, a contract that a bank holding company has entered into with a service provider to perform services for it or functions on its behalf satisfies the provisions of section III.D., even if the contract does not include a requirement that the servicer maintain the security and confidentiality of customer information, as long as the bank holding company entered into the contract on or before March 5, 2001.

[66 FR 8636, Feb. 1, 2001]

PART 226—TRUTH IN LENDING (REGULATION Z)

Subpart A—General

Sec.

- 226.1 Authority, purpose, coverage, organization, enforcement and liability.
- 226.2 Definitions and rules of construction.
- 226.3 Exempt transactions.
- 226.4 Finance charge.

Subpart B—Open-End Credit

- 226.5 General disclosure requirements.
- 226.5a Credit and charge card applications and solicitations.
- 226.5b Requirements for home equity plans.
- 226.6 Initial disclosure statement.
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- 226.8 Identification of transactions.
- 226.9 Subsequent disclosure requirements.
- 226.10 Prompt crediting of payments.
- 226.11 Treatment of credit balances.
- 226.12 Special credit card provisions.
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- 226.14 Determination of annual percentage rate.
- 226.15 Right of rescission.
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Subpart C—Closed-End Credit

- 226.17 General disclosure requirements.
- 226.18 Content of disclosures.
- 226.19 Certain residential mortgage and variable-rate transactions.
- 226.20 Subsequent disclosure requirements.
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Subpart D—Miscellaneous

- 226.25 Record retention.
- 226.26 Use of annual percentage rate in oral disclosures.
- 226.27 Language of disclosures.
- 226.28 Effect on State laws.
- 226.29 State exemptions.
- 226.30 Limitation on rates.

Subpart E—Special Rules for Certain Home Mortgage Transactions

- 226.31 General rules.
- 226.32 Requirements for certain closed-end home mortgages.
- 226.33 Requirements for reverse mortgages.
- 226.34 Prohibited acts or practices in connection with credit secured by a consumer's dwelling.
- 226.35 [Reserved]

Subpart F—Electronic Communication

- 226.36 Requirement for electronic communication.

APPENDIX A TO PART 226—EFFECT ON STATE LAWS

APPENDIX B TO PART 226—STATE EXEMPTIONS

APPENDIX C TO PART 226—ISSUANCE OF STAFF INTERPRETATIONS

APPENDIX D TO PART 226—MULTIPLE ADVANCE CONSTRUCTION LOANS

APPENDIX E TO PART 226—RULES FOR CARD ISSUERS THAT BILL ON A TRANSACTION-BY-TRANSACTION BASIS

APPENDIX F TO PART 226—ANNUAL PERCENTAGE RATE COMPUTATIONS FOR CERTAIN OPEN-END CREDIT PLANS

APPENDIX G TO PART 226—OPEN-END MODEL FORMS AND CLAUSES

APPENDIX H TO PART 226—CLOSED-END MODEL FORMS AND CLAUSES

APPENDIX I TO PART 226—FEDERAL ENFORCEMENT AGENCIES

APPENDIX J TO PART 226—ANNUAL PERCENTAGE RATE COMPUTATIONS FOR CLOSED-END CREDIT TRANSACTIONS

APPENDIX K TO PART 226—TOTAL ANNUAL LOAN COST RATE COMPUTATIONS FOR REVERSE MORTGAGE TRANSACTIONS

APPENDIX L TO PART 226—ASSUMED LOAN PERIODS FOR COMPUTATIONS OF TOTAL ANNUAL LOAN COST RATES

SUPPLEMENT I TO PART 226—OFFICIAL STAFF INTERPRETATIONS

AUTHORITY: 12 U.S.C. 3806; 15 U.S.C. 1604 and 1637(c)(5).

SOURCE: Reg. Z, 46 FR 20892, Apr. 7, 1981, unless otherwise noted.